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JPMorgan

World Financial Markets

November/December 1991

U.S. "double dip" affirms lasting low inflation

The U.S. economy is contracting again. Cutbacks in household spending impelled by new pessimism on jobs is leading to retrenchment by business.

- Defense cuts and municipal budget cutting feed the new downturn.
- Large deficits constrain fiscal initiatives for growth, but the Federal Reserve will lead, and succeed, in stimulating a revival in mid-1992.

Amid the gloom over the renewed downturn and unjustified concerns over excessive policy stimulus, the extent and sustainability of the inflation reduction under way is not yet fully appreciated. The low nominal GDP growth of the past five years is entrenching disinflation for years to come.

- A 3% CPI trend will emerge and be established by the end of 1992.
- Long-term interest rates will fall in consequence, if perhaps erratically.

U.S. credit quality: manageable in recession

Increased bond yield spreads and credit rating downgrades are on the way. But on the whole, the responses to a second leg of recession will be modest relative to those triggered by the major shocks of the 1980s. This judgment presumes that vulnerable borrowers tighten belts; and that markets believe in economic recovery sometime in 1992.

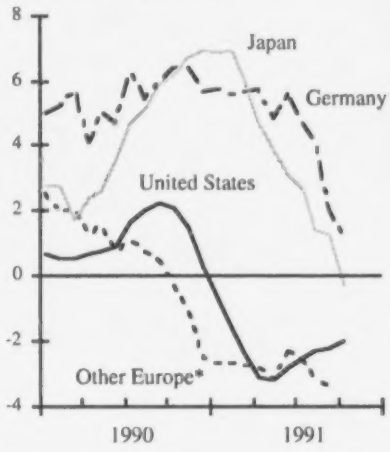
- Municipal risks extend beyond California and the Northeast.
- The automobile, wood and paper products, retailing, and telecommunications sectors are most vulnerable.
- Banks are hurt by recession, but efforts to build capital serve them well.
- Financial intermediaries will avoid aggressive new lending such as would accelerate national economic recovery or inflation.

Global economic outlook

Global growth prospects for 1992 are receding sharply, with no significant activity pickup until the U.S. downturn runs its course around midyear. Canada, Mexico, and Asian LDCs are most exposed to the U.S. decline, whereas Europe is overshadowed by German stagnation and recession risk.

- Inflation is headed downward nearly everywhere and interest rates are still too high.
- Besides Federal Reserve easing, the Bundesbank will ease once wages moderate; rate falls will be mutually reinforcing across the OECD.
- LDCs with sound domestic management, market orientation, and a record of dynamic growth will fare best in a slow-growth world.

World output in trouble*
percent change on year ago, 3-month moving average



*Industrial production: Japan and United States; manufacturing production: Germany and Other Europe (France, Italy, Netherlands, Spain, and United Kingdom).

Contents

U.S. "double dip" affirms lasting low inflation, 3

U.S. credit quality: manageable in recession, 13

Global economic outlook, 18
The Americas, 20
Europe, 22
Asia/Pacific, 24

Tables
Effective exchange rates, 26
Government Bond Index: performance and yields, 27

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Selected research on U.S. credit issues by J.P. Morgan

Municipal credit

Municipal Credit Review — City of New York,
Irene M. Walsh, Nov 13
Overview of the debt, economic, and fiscal position of the City of New York, including its financial plan, its relationship to the State of New York, and the proposed Medicaid program changes.

Defense Spending in the States, Robert A. Rich, Dec (forthcoming)
Update on the relative dependence of U.S. state and local governments on military spending, including the impact of prospective weapons systems eliminations.

Municipal Market Monitor, Robert B. Davidson III, Dec 13
Year-end wrap-up and 1992 outlook for specific segments of the municipal market (JPMS biweekly publication).

Corporate bond, equity, and high-yield credit

Credit outlook — financial institutions, industrials, and utilities
Short biweekly publications highlighting topical developments affecting companies/industries and their credit outlooks. Includes J.P. Morgan Securities' ratings and watch lists. A sampling:

Impact of payment rates on early amortization,
Anthony V. Thompson, Nov 19
Relates months needed to retire principal of a prepaying asset-backed security to credit card holders' balance pay-down rate.

Credit outlook — industrials, William Ingrassia, Aug 20
Reviews proposed changes in the regulation of interstate natural gas pipelines and the consequences for credit quality.

Credit outlook — industrials, Denise A. Gleason, Jul 23
Discusses forest products companies, including earnings prospects, product prices, and credit quality.

Economics

Sizing up the U.S. banking bill, Walter M. Cadette, Dec 6
Identifies key features of the legislation and comments on possible consequences for interest rate spreads and financial intermediation.

U.S. long-term decline in borrowing, Paul D. Mastroddi, Oct 18
Describes changes in the economy and funding practices that are expected to depress debt growth even in an economic upturn.

U.S. credit plan — little direct impact, Laurence G. Kantor, Oct 11
Highlights key aspects of the Bush Administration credit plan and explores the economic implications thereof.

Special corporate studies

Periodic in-depth analyses of industry issues.

Defensive strategies for leveraged securities, Bintoar Palar, Dec 4
Highlights vulnerability of leveraged equities and convertibles in a contracting economy and suggests possible investor strategies.

Financial flexibility framework, David A. Hendler, Jun 25
Explains JPM's framework for measuring a bank's ability to survive on its own internal capital resources.

Parent support framework, Anthony V. Thompson, Jun 24
Relates finance companies and their parents and quantifies explicit and implicit supports. Identifies companies exhibiting varying degrees of parent-related risk.

P&C risk-adjusted leverage, Amy C. Falls, Jun 23
Explains JPM's risk-adjusted leverage model for ranking property and casualty insurers based on reserve and capital strength relative to their varying mixes of business risk.

Electric utility special redemptions, Eunice T. Reich, Jun 18
Covers circumstances that enable utilities to call their bonds at par. Discusses special legal provisions and assists investors in determining how to avoid par calls.

U.S. "double dip" affirms lasting low inflation

By nearly every indication, the U.S. economy is contracting again. The renewed weakness is generating its own momentum through its impacts on household and business earnings and on state and local government budgets. These all spur second-round cutbacks in spending and employment. Double-dip recession is likely to continue well into 1992. This will have adverse consequences for the credit quality of many U.S. names, including some among state and local governments and others in the financial and nonfinancial corporate sectors (see article on page 13).

Recovery will require further encouragement from policy. The Federal Reserve will oblige by way of further short-term Federal funds rate reductions, which already have prompted a significant decline in the dollar against European currencies and the yen. Long-term interest rates will drift lower, albeit erratically, both in sympathy with the policy easing and in response to economic weakness. Interest-rate-sensitive domestic sectors will benefit accordingly. The lower dollar will mitigate the weakness in U.S. exports that might otherwise develop as the global economy stays subdued. And, thanks further to a stabilization of inventories, the economy has a reasonable chance to bottom out by midyear, with or without a possible modest fiscal boost. If so, the damage to the credit-standing of U.S. borrowers from the extended recession should be manageable — but not inconsequential against ever-present negative surprises that may befall specific names.

Beyond the near-term recession-recovery issue, this article observes that the current business cycle is far from "traditional" or "business as usual" in terms of its origins in the 1980s, its dynamics, and the aspirations for its management on the part of policymakers today. The implications for the future of inflation, interest rates, and the relative prosperity of major sectors of the economy are nontraditional too.

The U.S. economy is headed into its fourth consecutive year of little or no growth. Fundamentally, it still is struggling to overcome the consequences of the "excesses of the 1980s" — notably, high debt levels, overbuilding in many real estate markets, and the related thrift and banking industry crises. But equally important, the weakness reflects the tight bias of economic policy. Certainly, in the current cyclical environment, the federal government's immediate responsibility is to rekindle growth. The Federal Reserve, however, will retain its bent for monetary disinflation; and the longer-term focus of fiscal policy is likely to remain on budget-deficit reduction.

The overall disinflationary thrust of policy over the past half decade already has pushed down nominal GDP growth — to its slowest pace in thirty years. The slowdown in nominal activity has concentrated in real growth rather than inflation over the past three years. That mix will change as the weakness in real GDP gradually erodes inflation.

The effects of this transition have not fully unfolded in the economy at large. Nor is the reality of the transition yet fully appreciated in the markets. In particular, long-term inter-

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est rates still stubbornly reflect the higher-inflation environment of past years, not the low-inflation era ahead. The markets, however, will gradually do justice to reality. Further declines in bond yields therefore are coming over the next year or so.

Recession through mid-1992

The recession that began in mid-1990 has never truly ended. True, real GDP rose an average of 1 1/2% at an annual rate in the second and third quarters of 1991. Households were the main source of that temporary strength, as the end of the Gulf war triggered purchases — particularly of houses and autos — that had been postponed while hostilities were threatened or actual (fallen confidence and high oil prices depressed the economy last autumn and winter, as spending and production were postponed pending resolution of the conflict).

The spring and summer growth in the economy represented no more than a rebound from war-depressed levels. And the rebound was complete by the end of summer. Since then the economy has deteriorated steadily, because mere ending of the war could not establish the essential condition for a sustained recovery — significant increases in employment (see Chart 1). Modest hiring by factories and homebuilders occurred for a time, but this was swamped by continued layoffs in areas less affected by the war.

Overall construction employment declined through the summer and autumn, despite the hiring by residential builders. Nonresidential activity continued to fall sharply in response to high vacancies and plunging property values. The latter, along with a changed regulatory environment, caused the FIRE sector — finance, insurance, and real estate — to eliminate jobs over the summer.

The underlying trend for defense contractors remained intact. Their fate had been determined by last year's five-year budget accord on a 25% decline in real defense outlays by the mid-1990s. Industrial production of defense equipment never surged during the war (which was largely fought from inventories). Such production remains on a downtrend now and defense employment continues to contract — a tide that looks less reversible by the day as disintegration of the former Soviet Union runs its course.

Other employers during the summer of 1991 continued, with their usual lag, to adjust to the economy's output contraction that began in mid-1990. State and local governments have been the prime example. Their poor tax collections from last winter and spring opened up large budget gaps that have forced them to cut payrolls.

In the last several months, and notwithstanding the postwar euphoria, individuals have recognized the continuing deterioration of the labor markets. Their confidence has plummeted and so too has their spending (see Charts 2 and 3). Automobile sales have returned to near their Gulf war lows and other retail sales volumes are declining. In addition, the uptrend in housing activity, seemingly established over the first half of 1991, recently has stalled.

Reflecting the weakness of final demand overall, manufacturing and

Chart 1

Total nonfarm employment

percent change at annual rate over 3 months

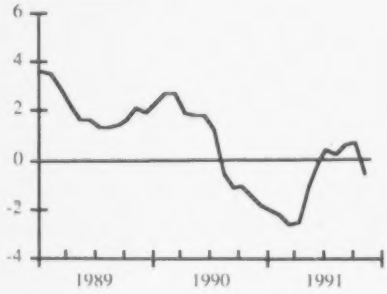


Chart 2

Consumer confidence

Conference Board index, 1985=100

Chart 3

Retail sales

excluding automobiles and gasoline, percent change, saar, 3 months over 3 months

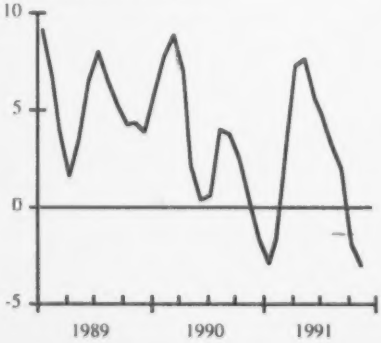


Chart 4

Manufacturing and trade inventories

percent change saar from 3 months ago

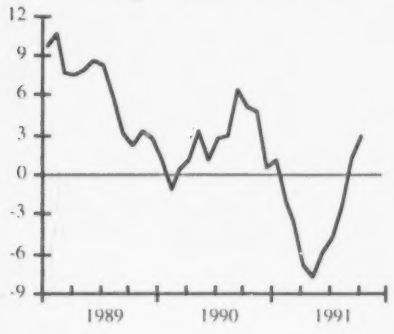


Table 1

Recent U.S. interest rate declines in 1991

percent

	Sep 6	Dec 17	Basis-point change
Federal funds	5.75	4.50	-125
Treasuries			
5-year	7.30	6.22	-108
10-year	7.80	7.18	-62
30-year	8.06	7.75	-31

trade inventories have been climbing again since last spring (see Chart 4). Absent revival in final demand, this points to an inevitable reduction in manufacturing output to stem the accumulation. Indeed, with no new boosts to spending on the horizon and no turnaround in employment imminent, the economy as a whole is headed for a further period of outright decline.

What recovery to come?

As the renewed economic downturn gets under way, it is far too early to pinpoint the bottom of the cycle with any degree of confidence. The negative dynamic that has now developed, combined with the lingering sources of weakness, makes it highly likely that substantial policy stimulus will be necessary to produce recovery any time soon.

The Federal Reserve has begun to provide support by lowering the Federal funds rate by 125 basis points in the past three months. Longer-term rates have moved lower as well, with 5-year Treasury yields falling by over 100 basis points and 10-year issues by more than 50 (see Table 1). These declines to date are unlikely to be adequate. Further declines are likely to follow quickly, once it is clear to all that the economy is, and will be, contracting for some time to come.

Concerns have been expressed as to the effectiveness of monetary easing in the current environment. It will have to offset, through stimulus in other areas, the ongoing cutbacks in nonresidential building, banking and insurance, defense, and state and local government. These are creating and compounding consumer gloom.

Pessimism should not be overdone. There already is some evidence that housing purchases are picking up as a result of lower mortgage rates. Houses, in fact, are more affordable today than in nearly two decades past. Presumably, all interest-rate-sensitive sectors will begin to exhibit benefit in due course — current economic trends, after all, reflect interest rate levels during the summer of 1991 when both short- and long-term rates were exceptionally high in real terms relative to the levels typical of past bouts with recession. The failure of the economy to respond as yet is not an indication of ineffectiveness of monetary policy but of the failure until recently to employ it aggressively.

Moreover, monetary policy is working through the additional channel of the dollar exchange rate. The dollar already has fallen from its summer highs, mainly through the widening interest rate differentials against the U.S. currency. The combination of a weak dollar and a very competitive U.S. manufacturing sector should lead to continued global market share gains for U.S. producers. During the 1980s, U.S. manufacturers did an excellent job in controlling costs and boosting their underlying productivity. In consequence, manufacturing unit labor costs are no higher today than they were a decade ago. With most foreign economies still managing at least a semblance of growth, and with imports likely to fall in response to weakening domestic demand, the trade deficit is likely to shrink sharply into next year. This will provide significant support to the U.S. economy.

In due course too, a probable turn in the inventory cycle will combine with the positives already at work in the interest- and exchange-rate-sensitive

sectors to put an end to recession and launch something of a recovery. The J.P. Morgan forecast places that development in mid-1992. But this is a reasonable hope, not a firm expectation.

If reality plays by this script, the current U.S. recession will represent the longest downturn since the 1930s. It will have lasted about two years, versus 16 months for both the 1973-75 and the 1981-82 downturns. Yet it will have generated no more than 1 1/2% peak-to-trough drop in real GDP — much less severe than the 2 1/2% decline averaged in the previous seven recessions. Thus the recession is expected to be long but mild. In these senses, it will mirror the 1983-90 expansion — likewise lengthy, and generally moderate on the upside.

More than a traditional cycle

The traditional business cycle is too narrow a context in which to interpret the economy's recent performance. Weakness of overall growth dates back to early 1989, when real GDP growth slowed to a 1 1/2% annual rate. At the time, the effects of the dollar's earlier 1985-87 depreciation began to fade. Export growth gradually returned to a sustainable pace whereas soaring exports previously (see Chart 5) had elevated 1987-88 real GDP growth to the 4%-5% range. They did so both directly and by encouraging business investment and the combination papered over domestic weaknesses already evident by 1987. Indeed, three of the most significant restraints on growth today were implanted as long ago as 1983-86.

First, the seeds of the past four years' plunge in nonresidential real estate prices were in the ground by the mid-1980s. Downtown office-building vacancy rates rose from 8% in 1982 to 16% in 1985, subsequently holding at that elevated level (see Chart 6). The same pattern generally has held for other types of nonresidential real estate, and in addition for multifamily buildings in which vacancy rates achieved virtually all their increase by 1986. The rise in vacancies was due partly to government policy. The Economic Recovery Tax Act of 1981 provided tax advantages — principally, favorable treatment of depreciation — which propped up the demand for nonresidential property despite rising vacancies. In addition, in their search for profitable investments, lenders fueled demand by relaxing loan standards and overvaluing future income flows from many properties. Sooner or later, the party had to stop. Nonresidential construction stopped growing in 1987 and began to contract in 1989 (see Chart 7).

Second, the economy's total nonfinancial debt ratio to GDP climbed from a pre-1981 norm of 1.35 to some 1.91 today and two-thirds of this jump occurred in 1983-85 alone (see Chart 8). Some of the increase was in federal government debt, incident to a burgeoning deficit that spurred economic growth through 1986; since 1987, however, federal spending has ceased to grow in real terms (apart from recent, and temporary, Gulf war outlays) and thereby has provided no prop to overall economic growth. Another portion of the overall debt increase relative to GDP can be attributed to corporate debt issued to retire equity — neutral, in itself, for economic growth.

Chart 5

Merchandise exports

percent change from year ago

Chart 6

Downtown office vacancy rate

percent

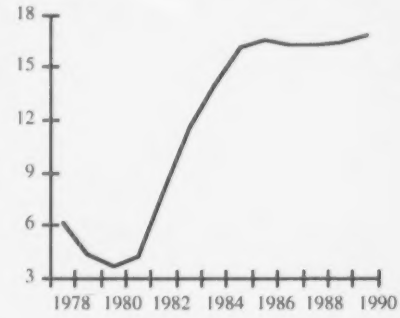


Chart 7

Nonresidential construction

billions of 1987 dollars, saar

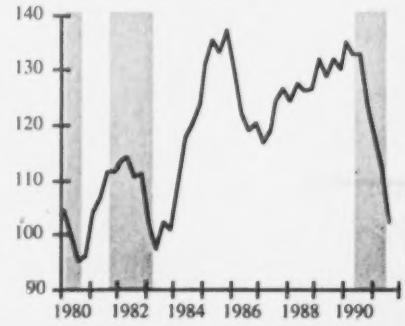


Chart 8
Domestic nonfinancial debt relative to GNP
ratio

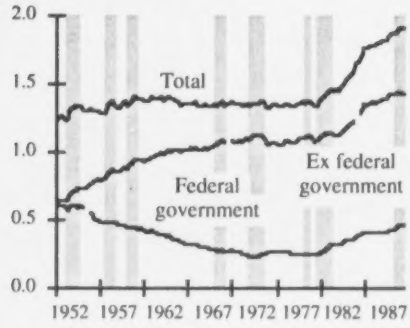


Chart 9
Housing starts
millions of units, saar

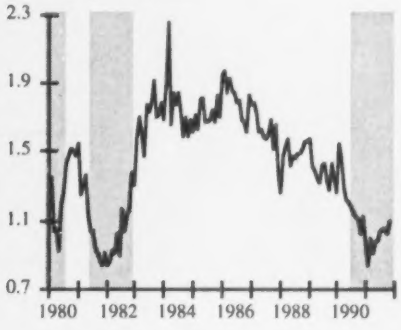
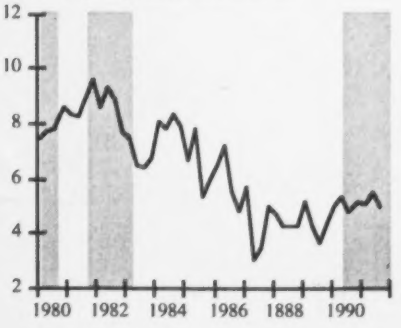


Chart 10
Household savings rate
percent of disposable income, sa



Fully half of the overall debt/GDP increase occurred through an explosion of residential as well as nonresidential mortgages. Home prices shot up on the East and West coasts. But again the party had to stop, and residential housing starts have declined in every year since 1987 (see Chart 9).

Third, the household savings rate fell from its previous long-term average of around 7% in 1982 to just 4% in 1987 (see Chart 10). During this period, large gains in asset prices, not only for homes (as just noted) but also for equities, prompted households to save less from current income. Households then turned cautious after the October 1987 stock market crash, boosting their savings rate steadily for a few years afterward. Real consumer spending growth slowed to a 1% pace at the beginning of 1989, down sharply from a 3% rate over the previous few years.

A final trigger for the current fundamental weakness in domestic spending did not develop until late in the 1983-90 business expansion. Following its usual tendency to lag the business cycle, the services sector was seized by euphoria toward the end of the decade. It overhired and let productivity slide, yet compensated employees so generously (particularly those of state and local governments) that services prices rose sharply relative to goods prices — averaging 5% versus 3%-4% annual inflation, respectively, over the course of the 1983-90 expansion. Ultimately, this was an untenable imbalance.

The foregoing perspective points to a painful, slow, yet inevitable, wringing-out of the excesses of the 1980s. In this light, the failure of overall economic recovery to take hold in 1991 following the end of the Gulf war simply reflects return to prewar conditions. Those conditions dictated low economic growth at the time. They are still at work today and will leave economic activity with a bias toward weakness for some indefinite (and probably extended) period into the future.

The role of policy: a dominant past, but a limited future

The timing of economic recovery will depend importantly on macroeconomic policy. Recently, financial markets have been concerned about the possibility of excessive stimulus. These fears are exaggerated. Neither monetary nor fiscal policy is likely to follow a course that would reverse the overall dis–inflationary trend of the last decade.

In any event, policy in a recession tells little about inflation in the subsequent expansion. For instance, taxes were cut dramatically in both the 1973-75 and the 1981-82 recessions, yet the 1975-79 expansion featured rising inflation whereas the 1983-90 upturn yielded surprisingly low inflation. The reason for the difference: policy (in particular, monetary policy) was adjusted quickly to restrain the economy in the 1980s' expansion. The Federal Reserve tightened early in that upswing to prevent the unemployment rate from falling too rapidly. Later, the government's macroeconomic policy stance turned decidedly restrictive in 1987, and has remained tight ever since.

On the fiscal side, the 1986 Gramm-Rudman-Hollings deficit-reduction act put an end to the budget's earlier

large boost to the real economy.* Ever since, the fiscal posture has been either a neutral influence or a drag on activity (see Chart 11).

The Federal Reserve has maintained a far more consistent policy than its fiscal counterparts since the early 1980s. Sustained monetary restraint has been its conscious aim. Its officials, in fact, frequently allude to this strategy for a slow grinding-down of inflation over time.

In particular, the Federal Reserve did not attempt to offset fiscal restraint, once this got under way later in the decade. In fact, it remained restrictive by some measures, and even tightened by others. The real Federal funds rate (the difference between the funds rate and CPI inflation) stayed in the 3%-5% zone until recently — an extremely high level by historical standards (see Chart 12). Another indicator of the central bank's stance suggests an actual tightening of policy. M2 money supply growth dropped sharply in 1987. M2 growth has remained at a slower pace since that time (see Chart 13), consistent too with the fairly steady reduction of the Federal Reserve's targets for this aggregate during Alan Greenspan's chairmanship.

* From 1983 through 1986, massive increases in the federal budget deficit played a key role in expanding the domestic economy. Rising "structural" (cyclically adjusted) budget deficits directly added an average of one percentage point annually to real GDP growth — and the boost was larger if multiplier effects are included. For its part, the Federal Reserve engineered persistently high real short-term interest rates. These joined with a level of unemployment that stayed elevated long after the 1981-82 recession to prevent the economy from overheating in mid-decade or inflation from rising as the expansion proceeded.

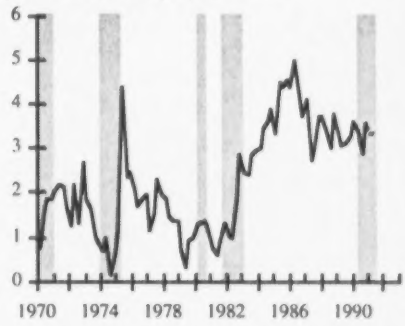
Of course, the central bank is unwilling to pursue lower inflation regardless of cost; thus its paramount near-term purpose is surely to restore growth in the economy. To this end, the Federal Reserve is likely to continue to lead the way, probably by pushing the Federal funds rate down below 4% by early 1992.

In addition, tax cuts may be implemented soon. Their exact magnitude is a key uncertainty in the near-term outlook. No multiyear growth stimulus is likely from fiscal policy, however, because the room today for fiscal action is severely limited by the size of the existing budget gap. In recessions in the past, tax cuts have totaled a minimum of 1%-2% of GDP — $50-$100 billion in today's economy. This time around, the most stimulative of the fiscal measures so far proposed — the plan put forward by Representative Rostenkowski — would provide a net tax cut of only $15 billion in 1992. Democrats and Republicans have been content to fight the next Presidential election by debating the distribution of the tax burden rather than by substantially altering the total amount of revenues collected. Thus one of the most threatening sources of overstimulus to the economy — politically driven fiscal expansion — seems largely disabled for the next few years.

The real surprise of the past year has been this reluctance to ease policy aggressively on either the fiscal or the monetary sides. The change probably signals new constraints on elected officials rather than a more enlightened willingness on their part to forego pro-growth measures in an election year.

The root of the new fiscal caution

Chart 11
Cyclically adjusted federal budget deficit*
percent of full-employment GDP



*A measure of the deficit's impact on the economy that abstracts from cyclical influences and excludes other items, such as the thrift bailout and other distortions, which do not affect real growth.

Chart 12
Real Federal funds rate
nominal rate minus percent change, saar in core CPI from 6 months earlier

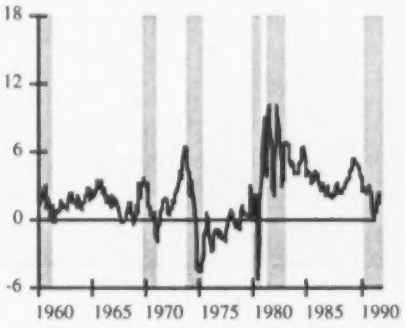


Chart 13
M2 money supply
percent change from year ago

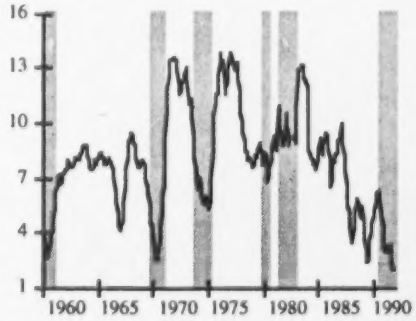
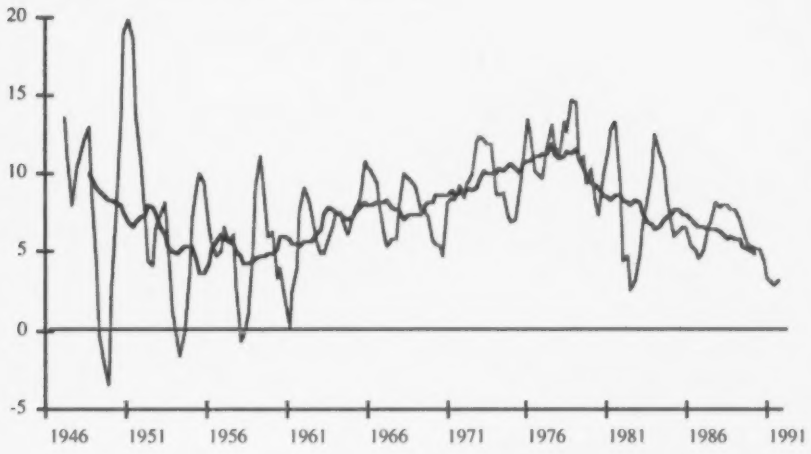


Chart 14

Nominal GDP growth

percent at an annual rate over 4 and 20 quarters



could well be the sense in the financial markets, in Washington, and among the voting public that the budget deficit already is "too large" for the long-term well-being of the nation. Strikingly amid a depressed job market, a Conference Board poll taken as recently as October rated the budget deficit as the third most important concern of U.S. consumers — trailing only medical costs and drug abuse. The Administration further seems worried that long-term interest rates could rocket so high on signs of ever-increasing budget deficits ahead, any large tax cut would be self-defeating as an economic stimulus.

Meanwhile, the Federal Reserve has little incentive now to abandon its policy of gradual inflation reduction. The policy is essentially intact — and working, as is apparent from the good inflation news recently. Yet remarkably, in the teeth of recession, the central bank's officials have not effectively countered asserted risks to inflation through their policy easings.

In sum, those expecting economic policy to be manipulated with an eye to the coming election have been disappointed so far. The caricature of the "short-sighted and growth-conscious politician" and a "weak-kneed" central bank is failing to predict policy accurately this time around.

A new and lower inflation trend

The restrictive macroeconomic policy stance of the past few years has slowed nominal GDP growth to a slim 3 1/2% in the latest year-on-year figures. This constitutes one of the smallest rises since the early 1960s. More important, the five-year trend in nominal GDP growth — a better indicator of long-term direction — is the lowest by far since the early 1960s and has reversed all the acceleration of the 1960s and 1970s (see Chart 14). The slowdown in nominal GDP is corroborated — and perhaps confirmed for the future — by the slowdown in M2 growth noted above.

When nominal GDP growth changes course, real GDP tends initially to absorb most of the change. Inflation adjusts later, responding only slowly to the cumulative effects of economic developments of the prior two or three years. These argue that the groundwork for inflation reduction already has been laid firmly in place.

Until the 1980s, inflation improvement during recessions accomplished little more than an unwinding from the price surge typical toward the end of business expansions. In the 1983-90 upturn, by contrast, inflation never rose much, thanks to the Federal Reserve's efforts. The 5 1/2% year-on-year peak reached in early 1991 was barely above the 4%-5% of the prior eight years — and differed dramatically from experiences in the

expansions of 1975-79 (when inflation doubled) and 1961-69 (when it rose fivefold). The absence of any inflation surge at the end of the 1983-90 expansion suggests a downward underlying trend. This augurs a lower trough in response to the current recession and probably a lower peak too at the end of the next expansion.

The extra capacity in markets for labor and capital created by the weak economic performance of the past three years virtually guarantees that the process of disinflation that began in the 1980s will bring inflation significantly lower in the early 1990s. The unemployment rate is now around 7%, well above the 5%-6% rate considered full employment. In the mid-1980s, this level of joblessness pushed the growth in labor compensation costs down to 3%-3 1/2% annually (see Chart 15). That range is about one percentage point lower than the latest rise in the employment cost index (4 1/4% from year-earlier levels in the third quarter of this year, down from a peak of 5 1/2% in early 1990). The likelihood that the unemployment rate will move even higher over the next six months (to 7 3/4% in the J.P. Morgan forecast) raises the likelihood that the economy will revisit its former slower pace of labor compensation gains.

From a peak of 5 1/2% briefly attained in early 1991, "core" consumer price inflation (excluding food and energy) already has dropped to a 4 1/2% pace, year-on-year (see Chart 16). Admittedly, this latest figure is only in the middle of the 4%-5% range that characterized nearly all the 1983-90 business expansion. The past six months alone, however, have shown an increase at only a 3 1/2% annual rate. And this decline has come despite an increase in excise and sales taxes that, in themselves, have provided a temporary boost to price gains.

Over the coming year, even further improvement in inflation should become visible, to a 2 1/2%-3% pace by the end of 1992. Granted, this low range may overstate the extent of the decline in the underlying inflation trend, inasmuch as it would reflect the worst of the recession. Even so, a longer-term trend of 3% seems likely.

Financial markets will naturally be skeptical. Following the double-digit growth in prices in the early 1980s, the markets required several years to convince themselves that inflation had sunk permanently lower in the mid-1980s in the teeth of fast economic recovery. Recollection of that happy conjunction from the past, and awareness that recovery this time promises to be hesitant (and still distant), may prompt speedier market recognition of today's new, and even lower, inflation trend in the year ahead.

Long-term interest rate declines in the pipeline

The implications of a shift to lower inflation are far-reaching and still in progress. Interest rates are the most obvious example. The Federal funds rate has tended to average between 1.0 and 1.5 percentage points over the inflation rate over long periods of time. If the inflation rate is truly around 3%, instead of the 4 1/2% average of the last business expansion, then a "normal" level for the Federal funds rate would be 4 1/2%-5% when averaged over the business cycle (but lower in recessions and higher in expansions). Short-term rates already have reached this lower level, although they are

Chart 15

Employee compensation

civilian nonfarm, sa, percent change over year ago

Chart 16

CPI excluding food and energy

percent change from year ago

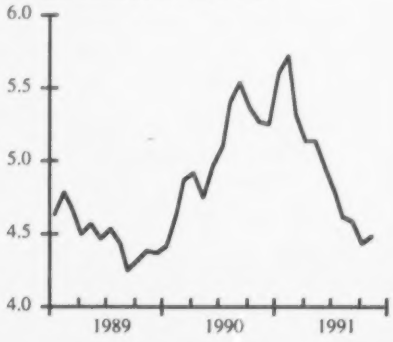


Chart 17

30-year Treasury bond yield

percent per annum, average

likely to move lower again over the next three months in response to the recession.

Long-term rates, by contrast, are only grudgingly reflecting the staying-power of lower inflation. For instance, the 30-year U.S. Treasury bond yield varied within a range of 8%-9% from late 1987 through this past summer (see Chart 17). Over that period, the inflation premium implicitly embedded within bond yields was probably around 4 1/2% — the average inflation rate of the past eight years and, until this summer, the rate expected to persist in the foreseeable future. If inflation does remain at 3% for an extended period, investors are likely to accept progressively lower yields until the inflation premium is 100 or more basis points lower than today's.

Apart from the inflation premium, the real (or after-inflation) yield on bonds may decline from the 4% average of the 1980s. Diminished demand from domestic borrowers following the debt boom of the 1980s may warrant a lower figure for the future. This conjecture is fortified by some possible upward tendency in U.S. public and private saving; and by the prospect of lower international interest rates in real terms as the high investment demands of the late 1980s fade from memory. Nor is it negated by the sporadically fashionable, yet realistically questionable, theory of impending global "capital shortage."

Taken together with the posited 3% inflation trend, all this points to a range no higher than 6%-7% over the next several years for nominal yields on the 10-year Treasury bond, and a somewhat higher range on the 30-year issue.

Losers and winners from the inflation transition

It already is becoming evident that the transition to low inflation has major ramifications for profits in some economic sectors. Those that have "locked in" nominal costs will have the greatest trouble. Most conspicuous will be the plight of borrowers exposed to lower nominal demand growth yet unable to refinance at lower rates or to issue equity. In this light, the intensifying problems in some segments of real estate — the most credit-intensive sector of the economy — are not surprising and will not be resolved quickly.

Also affected are services producers that committed themselves to a high cost structure in the last business expansion, either through extremely generous labor settlements (as in the case of state and local governments) or overhiring (as in the case of retailers). While the good times rolled, growth in their unit labor costs was high, yet, for years on end, they had little trouble passing them along to consumers. They then were unprepared for eventual consumer resistance, manifest in the recent decline in services price inflation to a 3 1/2% annual rate during the past six months (against the 5% typical of the 1983-90 period). Thus only now are services producers being obliged to recognize the lower inflation environment in the economy at large. Their one means to survival, let alone return to prosperity, will be resolute and sustained focus on productivity improvement. Amid less-than-ebullient demand, this implies strict payroll discipline (and consequent job cuts) for a considerable period ahead.

The economy at large will draw ben-

efit by such discipline in a major cost sector where the trait hitherto was notable for its absence. Not only will consumers gain but also the manufacturing sector should benefit through a lower cost trend in the many production inputs that it purchases from the services sector — a development that will bode well for U.S. exports.

Exports already have provided one of the U.S. economy's few bright spots over the past year. U.S. factories adjusted to a low inflation environment in the mid-1980s — ahead of the rest of the economy — under the pressure of intensifying foreign competition spurred by the dollar's strength during the first half of the decade. During that period, manufacturers cut costs across the board, increased capital and labor productivity, scaled down labor's expectations for employee compensation, and improved product quality. Even after the dollar depreciated against the major OECD currencies later in the 1980s, global competition stayed keen. U.S. manufacturers were able to score major gains in export market share as well as take advantage of a fast-growing global economy. And rather than fritter away their depreciation edge, as they had in the 1970s, they (and their workers) have remained firm in their new-found cost discipline. This now stands them in good stead to continue moderate export gains into the subdued global economy of 1991-92.

Economy will grow again, but inflation will stay low

The poor growth performance of the economy over the past three years has spawned increasing gloom about growth prospects for the next several years. And the contraction in the economy likely in the months ahead will fuel that pessimism.

While markets and policymakers should recognize that the recession retains full force — and, indeed, that further policy action will be needed to establish recovery even by the middle of next year — pessimism has become overdone. The current extended period of weakness reflects the combination of the economy's propensity for subdued growth following the 1980s' excesses; the restrictive bias of both fiscal and monetary policies; and, most recently, the dynamic process triggered by the prolonged weakness itself.

It is true that the effects of the 1980s' excesses will fade only gradually over a period of years. Monetary policy, however, is now moving to offset, rather than reinforce, these drags. Importantly, the progress that past policy restraint has made against inflation — and the further gains that are in train — together create room for the Federal Reserve to move; and to move decisively enough to establish recovery once the downward cyclical dynamic at work loses some of its present force.

More than likely, the recovery expected to get under way during the second half of 1992 will be slow by the standards of past business cycles. But it will be accompanied by significantly lower inflation — and thus, in a crucial and cheering sense, will be sustainable for years thereafter.

U.S. credit quality: manageable in recession

Table 1
Debt of the U.S. nonfinancial sector

	$trillion 1991Q2	Percent change q4/q4 1988	1989	1990	1991*
Total	10.8	9.1	7.5	6.5	3.4
Federal government	2.7	8.0	7.2	12.0	7.8
Other	8.1	9.5	7.5	4.9	2.0
Households	3.9	10.9	8.9	7.3	3.4
Consumer credit	0.8	7.3	6.3	2.3	-6.0
Home mortgages	2.7	11.9	10.6	12.7	5.3
Businesses	3.5	8.2	6.7	2.8	0.6
Corporate	2.2	6.5	8.7	1.0	-0.6
State and local government	0.7	8.2	4.9	2.7	1.1

* 1991Q2 relative to 1990Q4 at annual rate.

Related J.P. Morgan research

For a listing of selected recent J.P. Morgan studies on U.S. credit issues, see page 2 of this publication.

J.P. Morgan's monthly publications, *U.S. Markets* and *Global Markets*, December 1991 and prior issues, present the perspectives of J.P. Morgan strategists, researchers, and risk-takers on the implications of protracted U.S. recession for international interest and exchange rates, spreads, and equities.

Principal author of this article: D.K. Hargreaves, Nicholas J. Dazzo, Christopher M. Dillon, R.B. Davidson III, David A. Hendler, Paul D. Mastroddi, Peter G. Plaut, Eunice T. Reich, Robert A. Rich, and Anthony V. Thompson (J.P. Morgan, New York) contributed.

The "double-dip" path unfolding for U.S. economic activity through mid-1992 promises the longest downturn since World War II. Subsequent revival of activity will be modest. And CPI inflation will stick around 3%, or below, for the foreseeable future. On these key points, J.P. Morgan's outlook sharply departs from most expectations held in the financial and investor communities (and the government and business sectors) just a month or two ago.

The implications of such a shift in macroeconomic outlook are not yet embodied in financial market perceptions of credit quality. This article addresses the likely consequences for borrowers in the municipal, corporate, and financial sectors.

In all three sectors, the markets are likely to mark up funding spreads for borrowers in general, and more particularly for those deemed most adversely affected by the changed economic climate. In addition, the ratings agencies will formally downgrade some of these borrowers.

For the totality of U.S. borrowers and lenders, the incremental credit quality problems induced by extended national recession should prove manageable. Spreads and ratings will shift much less than in the 1981-82 recession (or 1990's flight from much bank paper). Both, however, will be more vulnerable than before the recession to negative surprises from unlikely quarters — and to doubts that economic recovery will materialize before late 1992.

On this latter point, renewed impairment of borrower creditworthiness combined with the new bank "reform" legislation which does nothing from the supply side to encourage sound lending by banks means that the economic recovery is unlikely to benefit from improved credit availability.

A lagging consensus

Until quite recently, the consensus view called for fairly steady U.S. economic recovery from a low point last spring. Nationwide, the recession then would have been no worse than moderate, of only three quarters' duration, and one that had merely accentuated temporarily a (arguably, much needed) reduction of net borrowing growth by the nonfinancial sector (see Table 1). Even were the recovery mild by historical standards, it would alleviate pressures on state and local government finances and buoy corporate cash flow — not only through gains in real economic activity but also through the gradual return of CPI inflation toward the 4%-or-higher pace that many borrowers and lenders took for granted.

Instead, despite the help coming through from lower interest rates, quick overall relief to the finances and credit standing of U.S. municipal and private borrowers stands in doubt.

The public sector

The former consensus view has permeated fiscal actions, or the lack thereof, throughout the U.S. public sector. At the **federal government** level, they have enabled quite easy political and market acceptance of a FY1992 deficit in excess of $350 bil-

lion (the Congressional Budget Office estimate), thanks in part to hopes fostered by the late-1990 budget accord for improvement once economic recovery resumes. The attendant rise in federal debt worsens long-term fiscal problems, but poses no important credit quality question in a purely domestic context (though some, perhaps, to international investors).

State and local governments have implemented stiff tax increases and expenditure cuts the past year or so, many taking effect in recent months. They have first had to catch up with the financial impairment wrought by several years of slow economic growth nationally — during which growth in state and local government payrolls accelerated and operating deficits deepened (see Chart 1). The actions taken substantially exhaust municipal revenue capacity (engendering taxpayer resistance). And, marking a severe drag on the national economy from this sector, job cuts will continue well into 1992. In most cases, fiscal corrections have been commensurate with the consequences of a moderate and short-lived national recession superimposed on longer-established local economic trends. Where corrections have been inadequate or particularly burdensome relative to local resources and needs, credit downgrades have been warranted, but not in extraordinary numbers so far (see Chart 2).

Local, indeed regional, conditions and prospects within the United States are highly diverse. Well known, and long-standing, is the fiscal plight of public authorities in New England and, more broadly, the Northeast in the wake of the real estate and services boom of the mid-1980s. More recently, defense cuts, a belated real estate downturn, and consolidation pressures in banking and insurance have combined to undermine California finances. Less noticed pressures are multiplying on governmental entities in areas, such as Texas and the Carolinas, that had been thought exempt from the fiscal limits facing the standard problem names in old industrial states and cities.

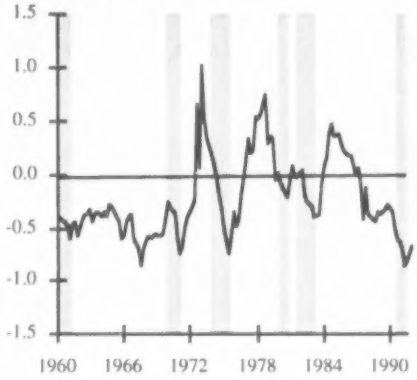
Renewed national recession can only aggravate difficulties in the year ahead, particularly now that many "one-shot" fiscal savings have been exhausted. Partial relief will come from interest cost savings consequent on Federal Reserve easing. But difficulties will be compounded insofar as public-sector planning ignores market forces. Only recently has the sector begun to recognize across the board the erosion of employment and wage demands in the private sector, and of inflationary behavior throughout the national economy. Conscious of limitations on traditional revenues, the sector is turning to growth-oriented revenue restructuring, spending disciplines (such as privatization and wage concessions against job protection), services reduction, and layoffs. All are major challenges for state and local governments.

Since July (when optimism on the national economy and local fiscal discipline may have peaked) municipal yields have been fairly static relative to those on Treasuries (see Chart 3). But this may signify only that investors' credit anxieties have not yet outweighed their desires to leave behind short-term, conservative, instruments whose yields have fallen. And because default probabilities inferred from municipals pricing do, in fact, suggest heightened perceptions of near-term credit risk, ratings down-

Chart 1

State and local government budget balance*

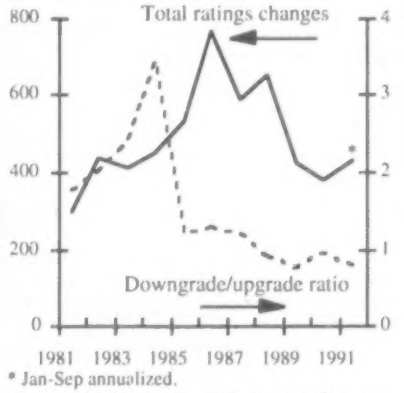
percent of GDP, saar, shaded bars indicate recessions



* Operating basis (current and capital transactions, excluding social insurance).

Chart 2

Municipal credit ratings



* Jan-Sep annualized.

Source: Moody's Investors Service Inc. The wave of ratings actions in 1986-88 was prompted by the 1986 tax reform.

Chart 3

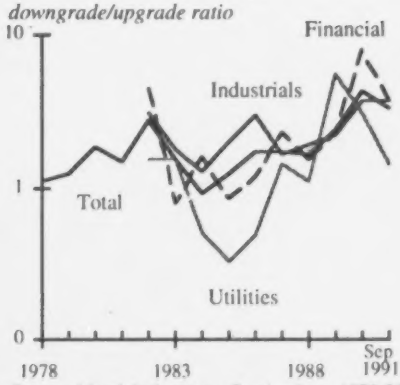
Municipal bond yields

percent of 30-year U.S. Treasury bond yield

Chart 4

Corporate credit ratings

downgrade/upgrade ratio



Source: Moody's Investors Service Inc. 1978-81 data based on changes in long-term letter grade (e.g., Aa to A); 1982-91Q3 data based on changes in "refined" letter grade (e.g., Aa1 to Aa2).

Chart 5

Nonfinancial corporate demand for funds

net debt and equity issuance as a percent of GNP

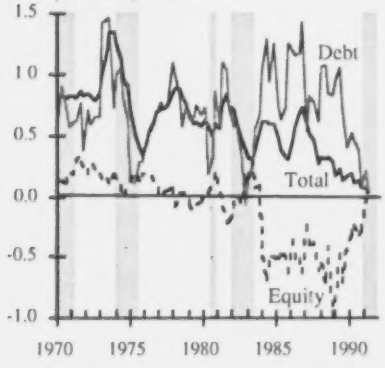


Chart 6

Corporate bond yield spreads

seasoned industrial issues, basis points over 10-year U.S. Treasuries

* The B spread peaked above 1200 basis points in late 1990.

Source: Moody's Investors Service Inc.

grades may be in store, once the agencies have the time and hard evidence needed to warrant decisions.

Even so, quality deterioration may not be severe for most individual borrowers, nor for the diversified (and often partly or wholly insured) municipals portfolios held by households and mutual funds (who together hold the bulk of issues today, banks having retreated since the 1986 tax reform). After all, market prices in principle allow for recession risk. So too do the more diligent analysts, whether or not their opinions translate speedily into public agencies' ratings.

When actual recession strikes, municipal financial impairment is par for the course — and is evident in the increased deficit projections now emerging from major borrowers, such as the near doubling of the projected 1992-93 New York State deficit from the $1.8 billion envisaged some months ago. Thus, even though some municipal issuers (such as utilities) are quite insulated, others are directly exposed to recession (some general and "junk" issuers plus, under current cost pressures, some health-care issuers too). Financial fallout may linger for years after the national economy recovers. Most often, however, it is of lesser import for creditworthiness than are secular trends in the local economies — unless reasonable expectations for correction go unmet or the recession is felt likely to prove deep as well as protracted. The JPM 1992 forecast does not foresee deep recession. Consequently, damage to municipal credit quality should, on the whole, be contained.

Nonfinancial corporations

Broadly similar considerations apply to U.S. corporate credits, and perhaps more sharply in market spreads and rating agency practices. Business entities have less claim to eternal life and not a few have engaged in financial engineering, whose weaknesses surface more quickly in hard times.

Chart 4 summarizes Moody's ratings actions since the late-1970s by the ratio of downgrades to upgrades. Overall, the striking feature is the increasing preponderance of downgrades over the period. In the industrial sector, during the mid-1980s until 1989, "event" risk associated with the junk bond/leveraged buy-out phenomenon contributed importantly. Built primarily on the tax code's discrimination against equity finance, this fad bred increased reliance on debt at the cost of credit quality. Only this year has this latter trend reversed through stepped-up equity issuance, complemented by the continuing reduction in overall corporate funds demand since 1988 (see Chart 5).

Nonetheless, the influence of the business cycle is apparent in ratings actions. Ratings plunged in the 1981-82 economic slump before picking up in the subsequent strong recovery. Something similar occurred in the avalanche of downgrades in 1990 followed by some slight easing in the pace during the first three quarters of 1991 (while the short recession scenario held credence).

A broadly parallel story is told in industrial bond yield spreads during the decade (see Chart 6). The 1986 peak had much to do with collapsed oil prices that year, the troubles of U.S. manufacturing under an overvalued dollar, and fear of event risk; 1990 brought the eclipse of the junk bond market, which sent yields on such is-

sues to the stratosphere. All spreads have widened anew in recent months — particularly on speculative-grade issues — consistent with the eroding macroeconomic outlook.

As the extended recession scenario gains adherents, spreads will widen further, especially for cyclical issues and despite today's pervasive business stress on belt-tightening. Ratings downgrades should intensify outside the most stalwart groups, such as integrated oil companies and electric utilities. Vulnerable sectors include automobiles, forest products and paper, and retail merchandising — activities exposed to consumption weakness — and telecommunications, in which sector deregulation has permitted some firms to diversify beyond their evident competence.

The financial sector

Beset by consumer and real estate exposure, finance companies, life insurers, and many banks are vulnerable in today's environment — not solely to the developing second leg of recession but, more important, to the longer-standing condition of heightened competition and risk-taking. In poorly managed cases, this has elevated the potential for outsize loan losses — whose actual occurrence is at the root of the conspicuous downrating of the sector since 1982.

Specifically, the troubles of commercial real estate long since prompted downgrading of most **banks**, and prominently of most money center and principal regional banks (see Chart 7), to levels consistent with the current macroeconomic forecasts. The industry's average rating plunged from low AA at the bank level (and high A at the bank holding company level) in the late 1980s to middle A (and low A) by mid-1991.

In addition, 1990's strict regulatory auditing stance for both real estate and highly leveraged transaction (HLT) exposures forced many banks to build loan-loss reserves dramatically, initially in some cases by running down "Tier 1" capital. Fortunately, the favorable conditions that prevailed through much of 1991 until recently enabled the healthier banks to raise from the public and private markets a first-half total of more than $5.7 billion in equity and equity-like funds — a significant boost to capital (after charge-offs) even as loan-loss provisioning continued to rise (see Chart 8). Higher total capital protects ultimate creditors against deterioration of bank asset quality.

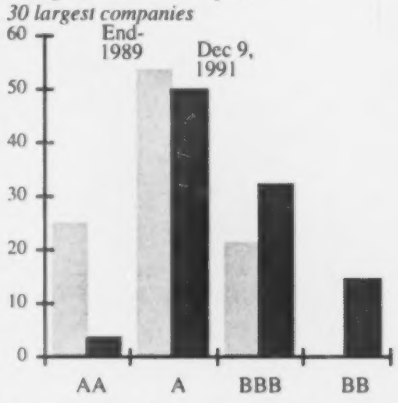
The bank group further has made strides during 1991 in buffering the negative effects of illiquid and delinquent real estate holdings. Liquidity has been enhanced on the asset side by moving to higher concentrations of securities and, on the liability side, by reduced reliance on purchased funding in favor of "core" (retail) deposit funding; this more stable funding gives banks time to "work out" loan problems rationally without resort to quick asset sales at prices damaging to bank capital structures.

Other help has come from modified examination procedures that encourage bank cooperation with borrowers. Most important, the rapid fall in the Federal funds rate has created a steep yield curve from which most banks can profit: net interest margins are their healthiest in over ten years, helping provide the wherewithal for loan-loss provisioning and the costs of real estate holding. Of course, high

Chart 7

Bank holding company credit ratings

ratings on senior debt of the 30 largest companies

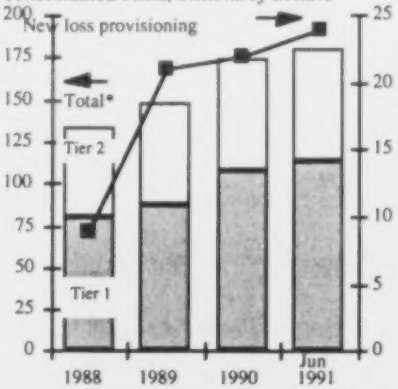


Source: Moody's Investors Service Inc.

Chart 8

Major U.S. banks: total capital and new loss provisioning

consolidated basis, billions of dollars

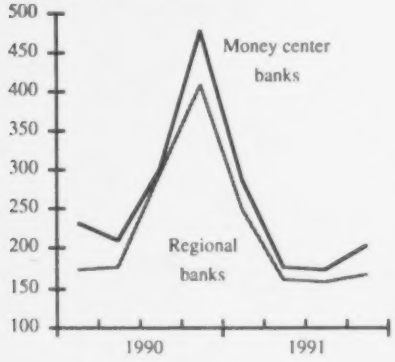


* Tier 1: predominantly equity capital; Tier 2: other regulatory capital, including accumulated allowance for possible credit losses on loans and leases (net of charge-offs).

Chart 9

Bank bond yield spreads

bonds (predominantly of major bank holding companies) actively traded in secondary markets, basis points over 10-year U.S. Treasuries



margins may not long withstand intensifying competition, for example in the credit-card sector.

Amid the pluses and minuses for the bank sector as a whole, some well-known names still must contend with troubled balance sheets and difficult business prospects. A number will be further downgraded as a result of a protracted recession, but probably less harshly than in the rapid and repeated actions during 1990. Downgrades may affect funding spreads adversely for specific entities and their peer groups but, this time, on the order of 10-50 basis points, not the hundreds of basis points witnessed in late 1990 (see Chart 9).

For most institutions, the more conservative capital and liquidity stance dictated by earlier weakness in commercial real estate now provides some cushion against fresh adversity. Amid protracted national recession, the cushion may be needed in 1992 against additional weakness in real estate, consumer, and commercial loans (including HLTs, on which 1991 experience may have bred undue optimism).

This judgment is not significantly affected by the "reform" legislation enacted last month. Besides recapitalizing the Bank Insurance Fund, this helps codify some of the changes in regulatory attitudes and policies under way for some time. It enhances the supervisory process; prompts early closure of undercapitalized institutions; and insists that regulators choose the least-cost method of dealing with failed institutions. Altogether, its stricture on regulatory "forbearance" may somewhat accelerate the closure of institutions nearing insolvency and promote the industry consolidation now under way.

But the legislation does nothing fundamentally to bolster bank profitability. The rise in insurance assessments mandated next year (to 30 basis points on covered deposits from just 8 points as recently as 1988) is likely to erode operating margins. These may, for the moment, be wide in their net interest component but in total are thin in relation to necessary loss provisioning against past business — let alone the panoply of future risks.

Nor does the legislation do anything else to encourage lending in the economic recovery to come, notwithstanding anguish in Washington over the "credit crunch." Allegedly, the crunch is manifest in the weakness of bank lending since last year (see Chart 10) as a supply-side phenomenon. In fact, it is one primarily occasioned on the demand side by a dearth of eager domestic borrowers of good standing in a recessionary economy.

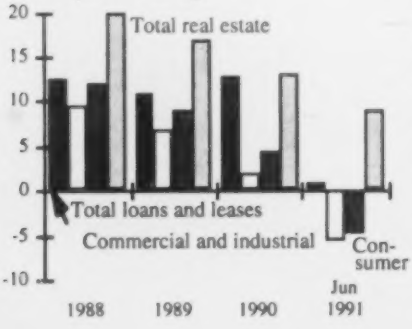
Plainly, economic recovery in the private sector will have to be based on improved confidence and credit quality on the part of consumers and businesses. That will occur eventually through turnaround in their income and asset price outlooks, assisted by lower interest rates.

Intrinsic to the process, however, will be passage of the inevitably lengthy time needed to strengthen balance sheets and otherwise work off the "excesses" of the 1980s. Recovery will not be led by some new enthusiasm for lending, by either banks or other financial intermediaries — all the more reason, therefore, for well-judged policy easing in the months ahead to reverse the economy's currently downward slide.

Chart 10

Domestic lending by U.S.-chartered commercial banks

annual percent change



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Global economic outlook in summary

percent change from previous year, except as noted; group averages and totals are for countries listed

	Nominal GDP/GNP	Real GDP/GNP			Consumer prices Dec-Dec			Current account					
	$ billions, 1990							$ billions			% of GDP/GNP		
		1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992
Industrial countries	15,965	2.5	0.9	1.2	5.2	3.6	3.1	-90.2	-27.4	-43.4	-0.6	-0.4	-0.4
United States	5,465	1.0	-0.8	0.1	6.3	3.0	2.8	-92.1	-6.1	-31.1	-1.7	-0.1	-0.5
Japan	2,958	5.2	4.4	2.8	3.5	3.4	2.4	35.8	67.5	66.0	1.2	1.8	1.7
Canada	575	0.5	-1.2	0.9	4.9	4.3	3.3	-19.0	-21.0	-20.0	-3.3	-3.6	-3.2
Australia	507	1.7	-2.1	1.2	6.9	1.4	3.4	-14.5	-11.0	-11.0	-4.8	-3.7	-3.5
Western Europe	6,460	2.7	1.0	1.4	5.1	4.5	3.9	-0.4	-56.8	-47.3	-0.1	-1.1	-0.8
Germany	1,518	4.7	3.1	1.0	2.8	4.2	2.9	44.7	-24.1	-13.9	2.9	-2.8	-1.4
France	1,197	2.8	1.3	1.6	3.4	3.0	3.1	-8.4	-5.3	-4.9	-0.7	-0.4	-0.4
Italy	1,105	2.0	0.8	1.8	6.4	6.0	5.3	-14.4	-16.0	-18.0	-1.3	-1.4	-1.6
United Kingdom	848	0.7	-2.4	1.3	9.3	4.1	4.4	-24.6	-11.9	-8.7	-3.0	-1.4	-1.1
Belgium	197	3.4	1.7	1.6	3.5	3.1	3.2	5.0	3.7	2.5	2.5	1.8	1.3
Denmark	130	1.6	1.0	1.5	1.9	2.5	2.5	1.5	1.7	1.3	1.2	1.3	1.0
Finland	138	0.0	-6.0	-1.0	5.3	3.0	4.2	-6.7	-6.1	-4.1	-4.9	-4.2	-3.5
Netherlands	276	3.4	1.8	1.0	2.6	5.0	3.7	9.9	8.7	7.9	3.6	3.1	2.9
Norway	106	1.8	2.5	2.4	4.5	3.5	3.5	3.6	4.2	3.7	3.4	4.1	4.1
Spain	488	3.6	2.6	2.7	6.5	5.7	5.7	-15.7	-17.3	-18.6	-3.6	-3.2	-3.3
Sweden	227	0.3	-1.5	0.3	10.8	8.0	3.0	-5.4	-4.9	-4.6	-2.4	-2.1	-2.0
Switzerland	230	2.6	-0.3	0.8	5.3	5.0	3.5	10.1	10.5	10.1	3.8	4.5	4.6
Emerging markets													
Latin America	938	-1.2	2.4	0.7	1,038	296.8	141.5	0.5	-13.1	-20.7	0.1	-1.1	-1.6
Argentina	103	0.4	5.0	5.5	1,344	85.0	15.0	1.8	-2.9	-2.1	1.7	-2.2	-1.1
Brazil	521	-4.6	0.0	-2.0	1,585	506.0	243.0	-2.2	-1.2	-0.4	-0.4	-0.2	-0.1
Chile	28	2.1	5.0	4.5	27.3	18.0	18.0	-0.8	-0.3	-1.6	-2.8	-0.7	-4.7
Mexico	238	3.9	4.9	3.2	29.9	17.3	12.6	-6.3	-11.3	-16.7	-2.6	-4.0	-5.1
Venezuela	48	5.7	9.3	4.5	36.5	30.0	22.0	8.0	2.6	0.1	16.7	5.8	0.3
Asia/Pacific	707	7.7	7.2	7.1	7.7	7.5	6.9	-3.8	-16.7	-18.7	0.4	-0.4	-0.6
Hong Kong	70	2.4	3.3	4.7	11.3	12.5	12.0	8.9	8.0	8.0	12.6	9.8	8.4
Indonesia	104	7.4	6.0	5.0	9.5	9.5	7.5	-3.3	-5.2	-5.0	3.1	4.5	4.2
Korea	238	9.0	9.0	8.0	9.4	9.6	9.0	-2.2	-10.0	-8.7	-0.9	-2.6	-2.0
Malaysia	43	9.8	8.5	6.5	4.1	5.0	5.2	-1.7	-4.3	-5.2	-4.0	-8.9	-9.8
Philippines	44	3.7	0.5	2.5	14.2	14.5	12.5	-2.7	-1.7	-1.7	-6.1	-5.0	-3.6
Singapore	36	8.3	6.8	6.2	3.8	3.0	3.2	2.4	2.8	2.6	6.7	7.1	5.8
Taiwan	162	5.3	6.7	8.5	4.6	3.7	3.5	10.8	10.0	8.5	6.7	5.6	4.3
Thailand	80	10.0	7.5	7.5	6.6	5.7	6.3	-7.1	-8.3	-9.2	-8.8	-9.1	-9.2

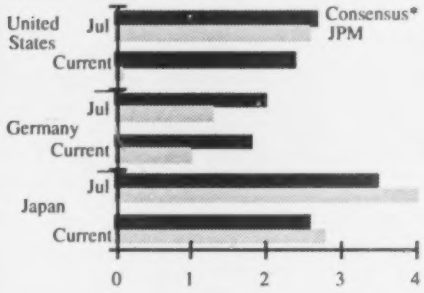
	Real GDP/GNP contributions, %						Private consumption			Business fixed investment			Budget balance* % of GDP/GNP		
	Domestic demand			Net exports change											
	1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992
G-7 industrial countries	2.4	0.7	1.1	0.2	0.4	0.1	2.3	1.2	1.5	4.7	0.1	-1.9	-2.0	-3.1	-3.6
United States	0.5	-1.1	-0.2	0.5	0.5	0.2	0.9	0.1	0.9	1.8	-3.1	-5.2	-2.4	-4.3	-5.6
Japan	5.4	3.2	2.3	-0.2	1.1	0.5	4.2	2.7	2.5	12.4	6.4	1.3	2.7	2.6	2.5
Canada	0.6	-1.0	1.0	0.8	-0.1	-0.3	1.3	-1.0	1.1	-3.2	-4.2	-4.8	-4.0	-4.5	-5.9
Europe (4)	2.9	1.4	1.8	-0.1	-0.2	-0.3	2.9	1.9	1.7	4.2	0.5	0.3	-4.2	-5.1	-4.8
Germany	5.1	4.5	1.6	-0.4	-1.1	-0.6	4.1	3.8	1.2	9.3	9.2	2.0	-3.7	-5.0	-4.4
France	3.2	1.2	1.5	-0.4	0.0	0.5	3.1	1.7	1.9	4.0	-0.5	1.2	-1.4	-1.5	-1.4
Italy	2.0	1.1	2.2	0.0	-0.3	-0.4	2.7	1.8	2.5	2.1	-0.8	1.5	-11.3	-11.1	-9.5
United Kingdom	-0.1	-3.3	1.8	0.8	1.1	-0.5	1.0	-1.0	1.4	-1.9	-11.9	-5.4	0.4	-2.8	-4.4

* General government definition (central, state, and local authorities plus noncommercial public-sector entities) for United States, Japan, and Canada; preferred national definitions for European countries.

Global economic outlook

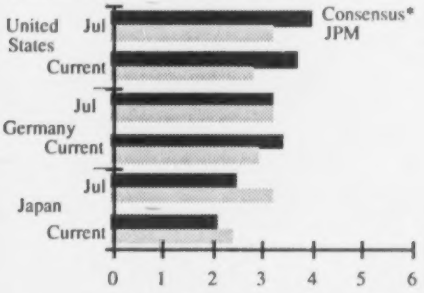
Real GDP/GNP: 1992 forecasts

July 1991 and current projections, calendar year average, percent change over year ago



CPI: 1992 Q4 forecasts

July 1991 and current projections, calendar year average, percent change over year ago



* Sources: "Blue Chip Economic Indicators," Capitol Publications, Alexandria, VA (United States); "Consensus Forecasts," Consensus Economics, London (Germany and Japan).

Exposure to fading OECD recovery

1990 exports to the G-3 and to OECD (all industrial countries) as percent of exporter's GNP

	United States	Japan	Germany	All OECD
United States	-	0.8	0.3	4.6
Japan	3.1	-	0.6	5.7
Canada	16.6	1.2	0.3	20.1
Australia	0.8	2.0	0.2	4.6
West Germany	1.9	0.7	-	21.7
Other Western Europe	1.7	0.6	4.6	20.5
Emerging markets*				
Mexico	9.2	0.7	0.2	11.6
Other Latin America	3.1	0.8	0.9	6.6
Asia/Pacific	10.4	6.7	2.1	28.5

* Regional groups as listed in the table opposite.

Global growth prospects for 1992 are receding sharply, with no significant activity pickup until the U.S. downturn runs its course around midyear.

- Canada, Mexico, and Asian LDCs are most exposed to the U.S. decline, measured by their bilateral export earnings relative to GDP.
- German stagnation, or outright recession risk, overshadows Europe. Europe's growth further is undercut by dollar weakness and diminished confidence spread from across the Atlantic.
- Only for Japan is the J.P. Morgan forecast a mite more optimistic than the consensus' — Japan is relatively insulated internally from export softening or yen appreciation.
- Japan, the United Kingdom, Scandinavia, and Australia face financial and banking risks to growth echoing the U.S. condition.

Inflation is headed downward: to under 3% in the United States (through most of 1992) and in Germany (later in the year, after the wage round); but little further inflation convergence beckons within Europe.

- Japan's inflation will dwindle for a time, but its core CPI rate is stuck in the 2.5%-3% range.
- Commodity prices will soften; oil prices, beset by high inventories, are vulnerable to market doubts on the timing of OECD recovery.

Interest rates still are too high, in nominal terms everywhere and especially in real terms (apart from Japan).

- The Federal Reserve will ease further, and U.S. bond yields trend lower, notwithstanding fears of fiscal mischief.
- German bond markets will anticipate Bundesbank easing once wages moderate; most other European markets will wait for Germany's, but all will deliver lower rates by end-1992.
- Rate falls will be mutually reinforcing across the OECD.

LDCs with sound domestic management, market orientation, and a record of dynamic growth will fare best in a slow-growth world.

- In Asia, the more industrialized economies fit this bill.
- Some in the ASEAN group have heavy commodity price and export exposure, as does Latin America.
- Mexico risks U.S. election-year paralysis of the North America Free Trade Area process. Delay is tolerable, but a lengthening of the odds on a successful conclusion could undermine investor confidence.
- Brazil's newly orthodox stabilization effort may not be sustainable amid probable recession and domestic discord.
- Eastern Europe's recessions and conversion pains impede stabilization and market reforms. The heirs to the former Soviet Union face transitional economic chaos, whatever their reform strategies.

The Americas

United States. The "double dip" in real GDP is unlikely to stabilize before mid-1992. J.P. Morgan's extended-recession assessment is presented in the lead article in this publication (see page 3).

- Another dose or two of monetary ease will be needed to deliver modest, unemployment-stabilizing recovery in second-half 1992.
- High joblessness and capacity slack will contain inflation around 3%, perhaps even less, for years to come.

Canada is destined to slip back into recession now that the renewed U.S. downturn and an appreciated currency are reversing the export pickup that had powered its short-lived spring and summer recovery. Declining commodity prices are depressing profits and capital spending by resource-based industries. Overall fiscal policy remains restrictive, despite some offset by Ontario's provincial stimulus efforts. And the housing rebound is fading as a force for growth under the weight of job worries and high real interest rates.

- Excess capacity and the poor outlook for activity are joining with a core rate of CPI inflation already below 3% to entrench moderated wage-price behavior throughout the economy.
- In consequence, the Bank of Canada's 3% average inflation target for 1992 is no longer a constraint on monetary easing.

Latin America. The faltering OECD recovery will undercut the region's export and growth prospects in 1992. Even so, most of Latin America should achieve moderate growth, recalling that 1991's good results have come mainly from successful domestic market opening and macro-management. Domestic demand and efficiency gains should underwrite 4% real GDP growth in 1992 on average for Argentina, Chile, Mexico, and Venezuela.

- Brazil, by contrast, is struggling to stabilize its economy and launch a reform program convincingly; it is likely to slip into recession early next year as tight monetary policy takes hold.

United States: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991		1992			Q4/Q4 change	
	1991f	1992f	Q3	Q4f	Q1f	Q2f	Q3f	1991f	1992f
Real GDP	-0.8	0.1	1.7	0.0	-2.0	-1.0	2.0	0.1	0.6
Private consumption	-0.2	0.8	2.3	-1.6	0.4	1.1	2.0	0.2	1.6
Business fixed investment	-7.0	-6.9	-3.5	-9.5	-11.4	-8.6	0.3	-8.6	-4.9
Residential construction	-10.9	6.2	11.9	1.1	4.0	6.3	11.2	-3.2	8.4
Inventories*	-0.2	0.1	2.6	1.2	-1.4	-1.1	0.4	0.9	-0.2
Net exports*	0.6	0.3	-1.6	1.0	0.8	0.6	0.2	0.2	0.3
Consumer prices	4.2	2.8	3.0	3.2	2.8	2.6	2.7	3.0	2.8
Civilian unemployment rate (%)	6.7	7.5	6.8	6.9	7.3	7.6	7.7		
Trade balance FAS/CVB ($bil.)	-66	-47	-77	-66	-53	-43	-42		
Current account ($bil.)	-6	-31	-42	-37	-37	-28	-26		

*Percentage-point contributions to real GDP growth.

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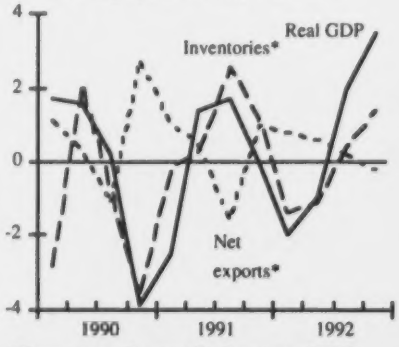
U.S. recession revisited

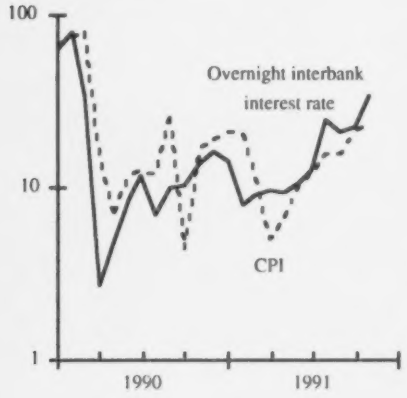
percent change quarter over quarter, saar



*Percentage point contributions to real GDP.

Brazil: a new inning for policy orthodoxy

Brazil: inflation and interest rates
percent per month



After the financial turbulence of recent months, which saw the spread between the official and parallel exchange rates soar as high as 50% following a 15% formal devaluation, the Brazilian markets have entered a period of relative calm. But the economy is mired in recession and external performance is worse than expected due to declining export competitiveness, poor harvests, and rising imports. Moreover, domestic political discord remains unresolved and the near-hyperinflation problem is far from tamed.

Inflation was reduced for a time by the "heterodox" stabilization program introduced in early 1991. The fifth such program in as many years, it featured a price freeze, increased public-sector prices, elimination of the government securities overnight market — but no fiscal adjustment. In the third quarter, amid rising fiscal deficits, declining confidence in government, and widespread expectation of another wage-price freeze, inflation began to accelerate.

By October, defensive price increases and devaluation pass-through boosted inflation to 25% — above the 20% mark expected to trigger a freeze. Instead, in early November the government sharply increased real interest rates, to some 7% *monthly*. These have encouraged capital inflows, allowing some rebuilding of international reserves and a narrowing of the official-parallel exchange rate spread to only 6% by early December. Price increases moderated, with some indices decelerating between October and November. Thus, while inflation remains at an unsustainable pace, its leveling-off has helped calm fears of another "shock" plan.

Confidence also gained on Brazil's early-December signing of an IMF letter of intent for a 20-month $2 billion standby program. Contingent on congressional approval of a $12 billion tax package, this would raise Brazil's primary (noninterest) fiscal surplus by 2% of GDP next year. In that case, real GDP would decline slightly again in 1992, but inflation should drop sharply — even to single digits by late-1992. Still, President Collor's declining popularity and Congress' acute political fragmentation leave Brazil's ability to follow the program open to question.

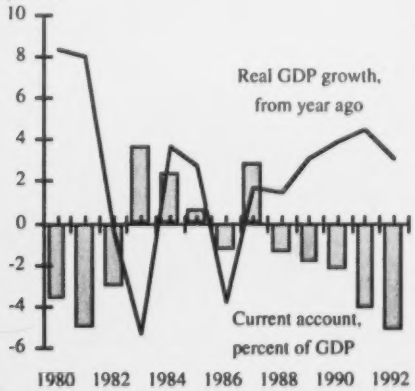
Western Hemisphere goods exports

	To United States			Total, % change	
	% of total		% chg.	Average	
	1985	1990	1991*	1986-90	1991**
United States	—	—	—	12.5	6.8
Canada	75	71	0	5.7	-1.1
Argentina	12	14	-10	8.0	-4.1
Brazil	27	24	-17	4.1	2.3
Chile	23	17	-11	16.9	6.5
Mexico	60	81	4	4.5	4.7
Venezuela	45	51	2	4.0	-13.1

*January-September.
**Calendar year, projected.

Mexico: external constraints on growth?

Mexico: real GDP and current account
percent



Mexican economic recovery has gathered speed since late 1989. Real GDP growth may be 4.5% in 1991, even as inflationary pressures continue to decline. Successful stabilization and reform programs, as well as the prospect of a North American Free Trade Agreement (NAFTA) with Canada and the United States, have inspired strong investor confidence and sizable private capital inflows into Mexico, lifting its international reserves by over one-third this year through September.

Against a backdrop of continued sound domestic economic policy, the major problem confronting Mexico is external. Thanks to the domestic growth pickup, the current account deficit will deepen to $11 billion this year (nearly double 1990's, yet easily financed) but could be headed for $17 billion in 1992 — magnified by the impaired export outlook (consequent on the renewed U.S. recession) and somewhat weaker oil prices. Some of the financing may have to come from international reserves.

That prospect should caution Mexico's economic authorities. The public-sector budget is programmed for small surplus next year, but scope exists for more aggressive monetary restraint. Moreover, NAFTA may be hostage to the U.S. electoral calendar. If the three countries cannot complete an agreement in sufficient time for a U.S. congressional vote by next spring, the Bush Administration may shelve the treaty until after November. At least a portion of private capital inflows into Mexico has been driven by expectations raised by the NAFTA talks, and a major fraction of the inflows has gone into short-term investments in the stock market and Mexican Treasury bills (Cetes) — funds that could be quickly withdrawn were confidence to flag.

Europe

Western European growth. The renewed U.S. downturn amplifies the sense that Europe's economic "recovery" in the year ahead will fall far short of the 2%-3% pace necessary to avert rising unemployment. Average real GNP growth may do no better than 1.5%, including virtual stagnation in Germany and no material emergence from recession in Finland, Sweden, or even, perhaps, the United Kingdom. Certainly, the risks are firmly on the downside.

- Spillover from across the Atlantic occurs partly through impairment of Europe's export markets and competitiveness (via a lower dollar) but also through a concomitant blow to consumer and business confidence. These days, European sentiment quite closely tracks U.S. confidence. The initial adrenaline from the crumbling of Communism and an approaching frontier-free "1992" has given way to dour realities, with manufacturing output dwindling nearly everywhere.
- Germany's dedication to tight monetary policy and restrictive fiscal policy (in the wake of the huge spending impelled by unification) has already brought two consecutive quarters of declining real GNP. But the Bundesbank will not relax its grip until next spring's wage round is clearly delivering settlements significantly below 1991's.
- Other European countries, weighed down by Germany, have little independent capacity to stimulate growth. Their monetary policies are hamstrung by EMS exchange rate commitments. And their fiscal policies are circumscribed both by the bond markets and, with the exception of France, by the constraints on deficits and public debt to be observed by the mid-1990s for full participation in European monetary union.

Inflation convergence. German inflation will not peak before next March, at around 4.5%, before receding below 3% by end-1992. In the meantime, other ERM countries will average distinctly lower inflation, particularly Belgium, Denmark, and France. This should reinforce downward pressure on European bond yields generally. Yet, even if sustained, this further convergence success on inflation may bring little spread reward in the markets, since it will mark marginal progress beyond the major accomplishments to date.

Europe: real GDP forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991		1992			Q4/Q4 change	
	1991f	1992f	Q3	Q4f	Q1f	Q2f	Q3f	1991f	1992f
Major 4	1.0*	1.5*	0.3	0.1	2.6	0.1	1.9	0.8	2.0
% change over year ago			0.7	0.8	0.7	0.9	1.4		
West Germany	3.1	1.0	-1.9	-0.9	6.7	-2.1	1.4	1.1	2.0
% change over year ago			1.9	1.1	0.3	0.4	1.2		
France	1.3	1.6	3.2	0.8	0.8	1.2	2.8	1.8	1.6
% change over year ago			1.4	1.8	1.8	1.5	1.4		
Italy	0.8	1.3	-0.4	0.8	0.8	1.6	2.8	0.6	2.3
% change over year ago			0.6	0.6	0.6	0.7	1.5		
United Kingdom	-2.4	1.3	1.2	0.1	0.4	0.5	0.6	-1.1	2.1
% change over year ago			-2.3	-1.1	0.1	1.2	1.6		

*All Western Europe, except Greece, Ireland, and Portugal.

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European inflation spreads over Germany

percentage points, year over year

	1989 Dec	1990 Dec	1991 Dec	1992 avg.	1992 Dec
France	0.4	0.6	-1.2	-0.5	0.2
Netherlands	-1.8	-0.1	0.8	0.2	0.8
Belgium	0.5	0.7	-1.2	-0.6	0.3
Denmark	1.7	-0.9	-1.7	-1.3	-0.4
Italy	3.4	3.6	1.8	1.7	2.4
Narrow band	**1.4**	**1.6**	**0.1**	**0.4**	**1.1**
Spain	3.8	3.8	1.5	0.9	2.8
United Kingdom	4.6	6.6	-0.2	0.7	1.5
ERM average	**2.3**	**2.9**	**0.2**	**0.5**	**1.4**
Sweden	3.5	8.2	3.8	0.2	0.1
Switzerland	1.9	2.5	0.8	0.6	0.6
Memo:					
German inflation	*3.1*	*2.7*	*4.2*	*3.8*	*2.9*

External demand on Europe

imports from Western Europe, excluding Germany billions of DM monthly, 3-month moving average, nsa

*Billions of DM at 1990 average exchange rate.

Russia sets a new interrepublic economic agenda

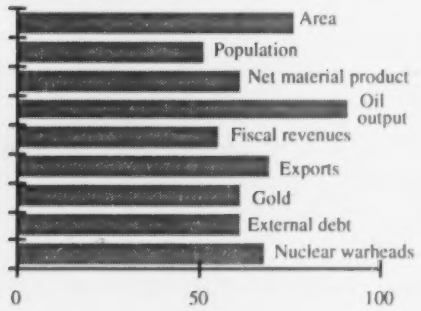
Soviet external debt

billions of dollars

*The higher Soviet-source total debt estimate is thought to include nonconvertible debts to former CMEA countries and some internal government debts in hard currency, and to be based on imperfectly consistent conversion rates into dollars.

Russia's primacy

percent of totals for former Soviet Union



Inability of the republics to adopt a joint position on key economic and financial issues has prompted Russia to seize the Union's monetary and fiscal control functions and set its own reform agenda. Both the Union's State Bank and its Bank for Foreign Affairs are to come under Russian control from January 1, 1992. Russia plans to slow monetary expansion by controlling both cash and credit issuance and by forcing cuts of up to 15% in the Union's defense and administrative spending. Prices for goods other than essential foods and fuel and public services are to be freed by January 1992. Oil prices are to be quintupled. And devaluation of the official exchange rate is planned, from R/$1.7 to R/$8-$10, along with a free interbank exchange rate, as steps toward internal convertibility.

Russia's unilateral strategy, its dominance of the old Union's output, strategic resources, fiscal revenues, and exports — and the speedy diversion of supplies and foreign exchange to Russia that its reforms would imply — cannot be ignored by the neighboring republics. They must opt for either outright economic separation or defensive collaboration. The latter course is suggested by the recent agreement to coordinate economic policy with Russia entered by the Ukraine and Byelorussia — an agreement that Kazakhstan and others may seek to join and one that may extend to some political and military matters in a still-tentative "commonwealth."

Although Russia's reforms draw heavily on G-7 recommendations, they will be hard to implement successfully in the current political environment. Full wage compensation may not be compatible with a stabilization budget, major expenditure cuts in the military-industrial complex (and resulting unemployment) will be fiercely opposed, and revenue considerations are barely addressed. Nor will exchange rate reform alone restore government control of hard-currency earnings, but instead could initially spur capital outflow.

For the West, this leaves unresolved the financial solvency of the members of the former Union, including Russia despite its export strength. The agreed G-7 debt deferral through 1992, which commercial creditors may join, provides some breathing space. But Soviet financial assistance is sure to remain on the G-7 agenda.

Central Europe: continued risks to stabilization and structural reform

Central Europe: a slow transition

*percent of total**

*Unemployment: percent of total labor force, October 1991; private-sector credit: to individuals and enterprises (including housing loans) as percent of total nongovernment credit, June 1991; private-sector GDP: percent of GDP, 1991.

The extended and severe downturns in Czechoslovakia, Hungary, and Poland are creating serious fiscal problems. Further real GDP contractions seem inevitable in 1992, ranging from 2% (Hungary) to 6% (Poland) and 8% (Czechoslovakia). Consequent erosion of revenues, growing social spending, and stepped-up outlays to keep state enterprises alive should keep fiscal deficits (and monetization) above 3% of GDP. Stabilization of monetary aggregates therefore may continue to prove difficult, despite the recent slowdown in monthly inflation to the 1%-2% range.

The external performance of the Central Europeans — impressive as it has appeared through 1991 — also is vulnerable. Poland's export drive has started to level off after an initial boost and Czechoslovakia's near-balancing of its current account owes much to import compression. Hungary's superior trade performance reflects the region's ongoing trade shift toward the EC (Germany in particular) which should gain further from the EC's free trade agreement effective in January 1992. But feeble market growth in Western Europe as a whole, and in Germany most of all, could dampen Central Europe's export opportunities and hopes for export-led recovery.

Central Europe's economic restructuring to date has accomplished little in the key financial sector, nor any major closures of unviable state enterprises. Substantial adjustment costs render large-scale privatization unlikely in Poland and Hungary in the near term, though Czechoslovakia still plans a massive privatization drive by June 1992.

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Asia/Pacific

Japan's economy is less sensitive than most to global demand trends and, despite weak industrial production, was surprisingly strong overall in 1991Q3. Still, the U.S. downturn will hurt Japan's business investment and exports (if not the trade surplus). Together with the hit from private financing constraints now slowing the economy, this will delay into late 1992 the resumption of real GNP growth near its 4% potential and leave calendar-1992 growth no higher than 2.8% — "recession" by Japanese standards.

- Underpinning for domestic demand comes from household real incomes and consumption, especially of services.
- Fiscal policy, including the Treasury Investment and Loan program, will be slightly less restrictive than planned, tapping "construction bond" finance to the limit and possibly resorting to "deficit bond" issuance.
- Further monetary easing is likely in the first quarter of 1992, when a fall in year-on-year CPI inflation also will help bond yields — even though underlying inflation will remain stuck in the 2.5%-3% range thanks to still-tight conditions in the labor markets.

Australia's real GDP dropped again in 1991Q3, confounding expectations for an increase and further setting back what will, at best, be minimal recovery in the year ahead with little help now expected from export demand. Low domestic confidence, manifest in consumer spending and housing, is at the heart of the overall weakness despite repeated interest rate cuts. Further cuts are in prospect while inflation expectations remain deeply subdued.

Asia/Pacific's industrializing economies remain heavily dependent on the U.S. export market in most cases, especially those at the middle-income level (such as Korea and Taiwan) that also specialize in medium-technology manufacturing vulnerable to lower-wage competition. Commodity exporters, including Malaysia, the Philippines, and Indonesia risk severe export price weakness in a slow global economy.

Japan: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991		1992			Q4/Q4 change	
	1991f	1992f	Q3	Q4f	Q1f	Q2f	Q3f	1991f	1992f
Real GNP	4.4	2.8	1.6	-0.5	4.0	4.5	3.4	3.0	3.8
% change over year ago			4.2	3.0	2.0	2.4	2.8		
Private consumption	2.7	2.5	3.6	-0.2	1.1	3.6	4.4	3.0	3.0
% change over year ago			2.9	3.0	2.7	2.0	2.2		
Business fixed investment	6.4	1.3	2.6	3.5	3.0	-4.2	-4.2	3.0	2.2
% change over year ago			5.2	3.0	1.5	1.2	0.2		
Residential investment	-6.6	0.5	-8.6	1.1	8.2	0.0	-1.1	-10.0	7.0
% change over year ago			-11.7	-10.0	-6.5	0.0	2.0		
Net exports*	1.1	0.5	-0.2	-1.6	3.1	1.0	0.6	0.4	0.4
Change over year ago			1.5	0.4	0.3	0.6	0.7		
Consumer prices (Tokyo, %oya)	3.3	2.8	3.3	3.4	2.6	3.1	3.0	3.4	2.4
Trade balance (customs, $bil.)	74	75	83	69	91	66	74	35	-1
Current account (nsa $bil.)	67	66	70	54	96	59	61	28	-5

* Percentage-point contributions to real GNP growth.

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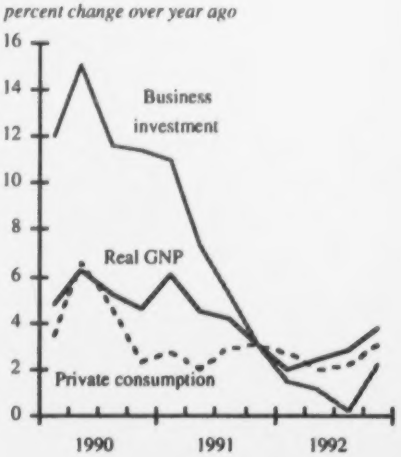
Japan: industrial sector

3-month moving average, percent on year ago

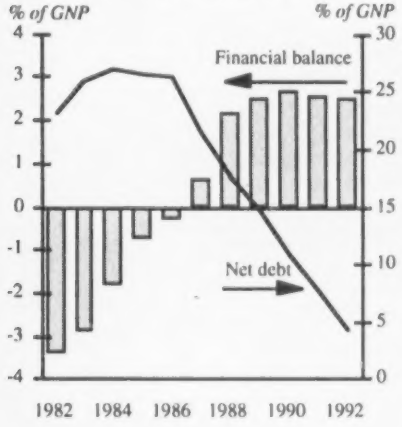
Japan: real GNP

percent change over year ago



Japan: public-sector finances

general-government basis, OECD measure



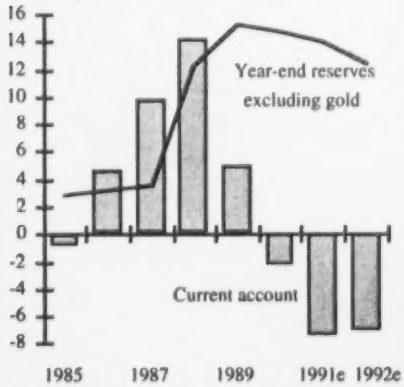
Asia/Pacific goods exports

	To United States			Total, % change	
	% of total		% change	Average	
	1985	1990	1991*	1986-90	1991**
Japan	38	32	3	10.2	7.3
Australia	10	11	-7	11.9	6.5
Hong Kong	31	24	-5	22.2	10.2
Indonesia	22	13	-12	6.7	10.3
Korea	36	30	-10	16.5	11.7
Malaysia	13	17	8	13.8	15.6
Philippines	36	38	1	11.9	3.7
Singapore	21	21	-1	18.2	6.5
Taiwan	48	32	-1	8.1	8.5
Thailand	20	23	15	26.5	20.6

*January-September.
**Calendar year, projected.

Korea: current account and international reserves

billions of dollars



Japan's fiscal conservatism: intact, but not unquestioned

The overarching goal of Japan's Ministry of Finance (MOF) in the 1980s was the restoration of fiscal rectitude by ending "deficit bond" issue and other devices deemed imprudent that had financed government red ink in the 1970s. The consequent fiscal restraint and the yen's appreciation after 1985, motivated monetary ease to keep economic growth rapid in the late 1980s. This spawned the "bubble" of financial and real estate excesses whose correction was the prime purpose of the Bank of Japan's tight monetary policy until seven months ago — a process at the core of the economy's current slowdown.

Not until FY1990 was MOF's deficit bond objective achieved, though the consolidated general government sector (including local authorities and off-budget operations such as Postal savings and National pensions) moved into surplus three years earlier; net public debt topped out in 1984 by the OECD's reckoning and today, by a wide margin, is the lowest among the G-7 countries. Many foreigners (and perhaps Prime Minister Miyazawa too) see ample scope for fiscal ease to complement monetary ease and buoy up economic growth.

Scope there may be, but MOF will not lightly retreat from its long-range macrojudgment of fiscal policy, still less while its regulatory competence is under fire. Indeed, red ink in the central government's "General" account may be portrayed as warranting new taxes and spending cuts, unless ruled out by the approach of next summer's Upper House election.

On a balanced view, the economic need for fiscal stimulus is not clear-cut. A period of subpotential economic growth would entrench inflation more firmly below 3%, while monetary easing and flexible use of government lending programs should eventually nudge growth upward — unless global developments so damage confidence as to force 1992 fiscal action beyond MOF's slim supplementary budget plan.

Korea: weakening externals, aggravated by domestic financial inefficiency

Close to the most vulnerable of the Asia/Pacific economies to the U.S.-led global economic slowdown, Korea has managed only modest export recovery this year (by past standards), following a poor 1990 performance. It is unlikely to fare much better in 1992, despite diversification to new markets, such as Eastern Europe. At the same time, Korea's fast economic growth — about 9% this year, and only a little lower prospectively in 1992 — has sent imports surging. The current account deficit has widened dramatically in 1991, and its forecast narrowing in 1992 presumes a sharp slowdown in fixed investment and imports. Large-scale external borrowing still will be necessary.

Korean difficulties on the export front are compounded by rapidly escalating labor costs at home, which also have kept CPI inflation inching close toward double digits. To halt erosion of their international competitiveness, Korean companies are seeking aggressively to upgrade product quality and technology, and their investment effort is central to the country's growth momentum. Yet many of these companies face a high cost of capital due to an inefficient domestic financial system, which lacks a government bond market, relies on interest rate controls, and has fostered expansion of nonbank finance companies leaving only one-third of total deposits within the banking system — weaknesses that severely impair the central bank's ability to control monetary growth and thereby counter inflation.

A cautious financial reform has been put forward to deregulate interest rates over six years; the program also will open the equity market to foreign investors, but limit their access to just 10% of a company's listed shares. The leisurely schedule risks exacerbating domestic economic distortions — or being overwhelmed by market forces, whose power and inflationary potential often are underestimated by countries attempting phased liberalization. Even so, Korea cannot backtrack. Financial liberalization has become a test case for judging its economic opening and the risk of trade frictions, especially with the United States and Europe, remains high in a slow-growth world.

Effective exchange rates

*index numbers, 1980-82 average = 100**

	1988	1989	1990	1990 Q3	1990 Q4	1991 Q1	1991 Q2	1991 Q3	1990 Nov	1991 Jul	1991 Aug	1991 Sep	1991 Oct	1991 Nov
Nominal against 15 other industrial-country currencies														
United States	88.0	91.3	86.5	85.3	81.7	82.8	87.7	87.6	81.1	88.9	87.8	86.1	85.3	83.8
Japan	181.6	172.8	156.8	154.5	168.5	165.9	167.6	170.4	169.9	170.2	170.0	171.2	175.7	175.0
Canada	95.6	100.5	100.7	101.5	100.0	100.7	102.8	103.3	99.7	103.1	103.2	103.5	104.3	103.6
Australia	61.9	65.6	62.4	63.8	59.0	59.6	62.3	63.2	57.9	63.1	63.3	63.2	62.7	61.2
Germany	121.8	121.0	124.9	124.3	125.8	125.7	122.9	123.4	126.0	122.8	123.4	124.0	124.0	125.1
France	85.7	84.9	88.2	88.2	88.8	87.7	86.2	86.2	89.0	85.9	86.2	86.4	86.3	86.8
Italy	79.8	80.6	81.3	81.2	80.6	80.8	80.2	79.9	80.7	79.8	79.8	80.1	80.1	80.1
United Kingdom	83.8	81.3	79.3	81.7	81.7	81.4	79.8	79.3	81.8	79.1	79.2	79.5	79.1	79.3
Belgium	94.6	94.2	97.7	97.7	98.2	98.4	97.1	97.2	98.3	97.0	97.3	97.5	97.6	98.2
Denmark	101.2	99.0	104.7	104.6	105.3	104.9	102.9	102.4	105.5	102.0	102.4	103.0	103.0	103.1
Netherlands	114.4	113.6	116.4	115.8	116.7	116.7	114.9	115.2	116.8	114.8	115.1	115.5	115.6	116.3
Spain	75.6	78.9	81.8	83.1	82.3	83.1	81.7	81.0	82.4	80.6	81.2	81.3	80.9	81.5
Sweden	80.3	81.2	79.0	78.6	78.0	78.3	79.1	78.5	77.9	78.4	78.5	78.6	78.6	79.1
Switzerland	121.9	115.8	121.3	123.9	123.9	122.7	120.7	117.9	124.1	117.9	117.8	117.9	117.8	117.4
Real (relative wholesale-price adjusted) against 18 other industrial-country currencies and 22 emerging-market currencies														
United States	92.5	96.6	92.3	91.2	88.7	89.7	93.5	93.2	88.2	94.5	93.4	91.7	91.7	90.4
Japan	128.7	121.3	107.4	105.6	113.7	112.3	113.3	114.7	114.4	115.0	114.3	114.7	117.5	116.5
Canada	104.3	107.7	103.4	104.2	100.5	100.6	103.5	103.3	100.2	103.8	103.1	103.0	103.5	102.3
Australia	91.8	98.3	94.6	96.8	90.7	91.2	94.6	95.8	89.0	95.6	95.9	95.9	95.0	92.8
Germany	106.5	104.0	107.3	106.6	107.9	107.5	104.0	103.6	108.1	103.1	103.6	104.2	104.2	105.4
France	102.3	99.8	103.8	103.9	104.7	103.3	100.9	101.0	104.9	100.6	100.9	101.4	101.4	102.3
Italy	104.3	107.3	109.7	109.6	109.3	109.2	106.8	106.5	109.5	106.2	106.3	107.0	107.2	107.5
United Kingdom	95.1	93.6	95.7	99.1	100.3	101.2	98.4	97.8	100.3	97.5	97.8	98.3	97.9	99.0
Belgium	81.4	79.5	83.8	84.4	84.0	84.4	83.6	83.7	84.1	83.3	83.5	84.2	83.3	83.8
Denmark	109.0	106.0	111.4	110.8	112.2	109.8	108.1	106.7	112.4	105.0	106.7	108.4	108.7	108.4
Netherlands	109.6	106.8	109.6	109.2	111.1	109.8	107.3	109.4	111.2	108.5	109.2	110.4	110.8	112.5
Spain	103.7	109.3	116.1	117.7	117.1	119.3	116.3	115.0	117.4	114.3	115.3	115.4	115.5	116.7
Sweden	100.0	104.8	103.3	102.8	102.0	102.1	101.8	101.0	101.9	100.6	100.9	101.4	101.1	102.4
Switzerland	126.7	118.4	128.2	131.4	131.4	132.1	132.2	130.0	132.8	129.9	130.8	129.4	128.0	131.3
Argentina	59.5	49.8	58.6	61.3	75.9	68.4	69.5	68.8	76.7	69.9	68.6	67.9	68.7	68.1
Brazil	81.1	98.1	117.5	115.3	97.5	91.3	89.9	94.5	96.4	93.7	95.8	93.9	78.0	69.9
Chile	60.7	62.2	59.9	60.2	61.3	61.6	65.9	66.5	60.6	67.3	66.4	65.8	72.0	71.9
Mexico	77.0	73.9	69.1	69.0	68.5	71.5	75.2	76.0	68.2	76.3	75.9	75.6	75.9	75.7
Venezuela	71.8	61.9	52.3	51.2	50.3	49.9	52.3	51.8	49.7	51.7	51.9	51.8	51.0	51.2
Hong Kong	90.3	98.4	98.7	97.8	98.2	97.9	108.1	108.4	98.7	109.2	108.0	108.0	109.9	110.3
Indonesia	53.7	55.3	54.4	54.3	51.7	52.4	54.9	56.1	51.4	56.2	56.5	55.7	55.2	54.5
Korea	82.1	92.1	84.8	83.4	81.8	82.4	85.5	84.7	81.3	86.0	85.0	83.0	81.5	80.6
Malaysia	79.9	79.4	75.6	74.6	73.2	73.7	76.3	76.1	72.8	76.8	76.1	75.5	76.7	76.0
Philippines	89.2	95.3	88.4	87.8	82.1	81.1	84.9	91.8	79.7	88.8	91.7	95.2	95.9	98.2
Singapore	73.0	78.0	80.4	80.0	80.5	80.4	82.5	84.0	80.4	83.9	84.3	83.7	84.0	84.1
Taiwan	95.0	100.7	93.7	92.3	91.3	91.0	92.9	93.8	90.9	94.2	94.0	93.2	95.8	95.3
Thailand	74.2	76.9	74.4	73.1	75.9	76.2	79.4	80.4	75.6	80.8	80.2	80.0	86.2	82.9

* A currency's nominal effective exchange rate is an index of its trade-weighted average value against the currencies of the country's principal trade partners. The real effective exchange rate, which adjusts the nominal index for relative price changes, gauges the effect on the international price competitiveness of the country's manufactures due to currency changes and differential inflation. The relative price changes are based on indices most closely measuring the prices of domestically produced finished manufactured goods, excluding food and energy at the first stage of manufacturing. The weights for the currency indices are derived from 1980 bilateral trade patterns of the corresponding countries.

J.P. Morgan Government Bond Index: total return performance

percent change, end of period from like preceding period

				1990				1991					
	1988	1989	1990	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Sep	Oct	Nov
In local currencies													
United States	6.8	14.0	8.6	-1.1	3.3	1.0	5.2	1.9	1.4	5.5	2.0	1.0	1.1
Japan	5.9	-1.5	0.8	-5.7	2.7	-4.4	8.8	2.1	0.5	6.1	2.1	0.9	0.7
Canada	9.1	12.8	7.4	-5.2	4.8	1.3	6.7	5.9	0.3	7.3	3.6	2.9	0.9
Australia	9.8	13.7	18.8	1.5	3.5	4.4	8.3	5.3	3.7	6.5	2.8	4.2	0.9
Germany	5.2	1.0	1.1	-3.3	1.3	0.4	2.7	4.1	1.9	2.3	0.7	0.7	0.9
France	16.2	4.1	7.3	1.4	2.4	-1.2	4.7	6.4	2.1	3.4	1.2	1.1	-0.2
Italy	11.6	12.0	14.6	3.3	5.2	2.3	3.1	4.9	3.9	4.0	2.0	1.9	0.0
United Kingdom	6.7	8.0	9.5	-6.0	7.2	1.0	7.5	6.7	0.8	7.2	2.6	0.3	-0.2
Belgium	8.7	2.0	8.8	1.9	3.0	-0.3	4.0	4.9	2.1	2.9	1.2	0.8	0.5
Denmark	17.3	5.0	10.2	2.0	4.1	-0.2	4.0	6.2	2.7	2.9	1.4	1.2	0.3
Netherlands	6.0	-0.2	3.3	-1.7	1.8	0.4	2.8	3.9	2.1	1.9	0.6	0.7	0.5
Spain	9.8	9.2	14.8	3.3	4.0	2.2	4.6	6.5	4.3	3.8	1.2	0.7	0.1
ECU	..	..	7.4	-2.2	3.9	0.6	5.1	5.9	2.5	3.8	1.7	0.3	0.2
In dollars													
United States	6.8	14.0	8.6	-1.1	3.3	1.0	5.2	1.9	1.4	5.5	2.0	1.0	1.1
Japan	2.6	-14.5	7.2	-14.1	6.5	5.3	11.3	-1.7	2.7	9.9	5.2	2.4	1.5
Canada	18.9	16.1	7.2	-6.2	5.3	2.0	6.4	6.0	1.8	8.2	4.5	3.8	-0.2
Australia	29.8	5.1	16.2	-3.0	8.7	8.9	1.2	5.6	2.6	11.0	4.7	1.6	1.6
Germany	-6.6	5.6	14.8	-3.3	3.1	6.5	8.1	-8.7	-4.2	11.2	5.8	0.1	3.8
France	2.2	8.9	22.4	2.9	4.4	5.1	8.4	-6.1	-4.2	11.8	6.0	0.2	2.9
Italy	-1.0	15.5	28.8	5.1	7.3	6.4	7.3	-6.2	-2.4	12.4	6.9	1.2	2.4
United Kingdom	2.5	-3.7	31.3	-4.0	13.7	8.2	11.1	-3.6	-6.4	15.7	7.0	-0.4	1.4
Belgium	3.7	6.7	25.2	3.1	5.9	5.5	8.7	-7.3	-4.0	11.8	6.3	0.3	3.5
Denmark	4.1	9.1	25.6	4.1	6.1	5.6	7.6	-6.4	-3.5	11.9	6.6	0.4	3.0
Netherlands	-6.4	4.5	17.2	-1.6	3.6	6.3	8.2	-8.7	-4.1	10.8	5.7	0.2	3.5
Spain	3.9	13.1	31.1	3.9	10.5	6.6	7.1	-3.4	-2.7	11.6	4.5	1.0	1.6
ECU	..	..	24.3	-0.6	6.7	6.6	9.9	-6.6	-4.0	12.3	6.5	-0.2	2.7
Global	5.0	6.8	11.8	-3.1	4.7	3.1	7.0	-0.8	-0.1	8.0	3.7	1.0	1.6
Global excluding United States	1.7	-2.4	15.6	-6.0	6.5	5.7	9.1	-4.3	-2.0	11.4	5.8	1.0	2.3

J.P. Morgan Government Bond Index: 10-year constant-maturity yields

*percent per annum, semiannual basis**

				1990				1991					
	1988	1989	1990	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Sep	Oct	Nov
United States	9.13	7.91	8.06	8.64	8.41	8.80	8.06	8.03	8.23	7.45	7.45	7.45	7.41
Japan	4.62	5.59	6.65	6.83	6.70	7.93	6.65	6.58	6.78	6.07	6.07	6.02	5.99
Canada	10.19	9.56	10.28	11.10	10.69	11.19	10.28	9.52	10.06	9.09	9.09	8.69	8.64
Australia	12.93	12.93	12.05	13.43	13.38	13.62	12.05	11.38	11.16	10.32	10.32	9.79	9.78
Germany	6.57	7.26	8.99	8.40	8.69	9.11	8.99	8.51	8.49	8.38	8.38	8.38	8.30
France	8.64	9.37	9.97	9.56	9.63	10.53	9.97	9.10	9.16	8.87	8.87	8.77	8.88
Italy	13.15	14.08	14.54	14.09	13.20	14.61	14.54	13.68	13.32	12.90	12.90	12.79	13.00
United Kingdom	10.31	10.20	10.96	12.11	11.76	12.19	10.96	10.12	10.49	9.58	9.58	9.69	9.87
Belgium	8.12	9.42	9.97	9.80	9.68	10.53	9.97	9.36	9.35	9.10	9.10	9.07	9.13
Denmark	9.39	10.25	10.49	10.51	10.20	11.01	10.49	9.38	9.28	9.06	9.06	8.94	9.04
Netherlands	6.55	7.84	9.15	8.73	8.84	9.29	9.15	8.73	8.75	8.77	8.77	8.76	8.80
Spain	12.16	14.12	14.60	14.48	14.43	15.11	14.60	12.52	11.94	11.30	11.30	11.47	11.68

* For each of the J.P. Morgan Government Bond Index countries, the data are calculated as the semiannual yield of the single most liquid bond component within four months of the stated maturity.

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JPMorgan

World Financial Markets

January/February 1992

EMU off the Maastricht launchpad

At Maastricht last December, Europe launched on a course intended to achieve monetary union (EMU) by the end of the century.

- Deepening of European integration enjoys strong momentum.
- EMU potentially offers Europe long-term economic gains.

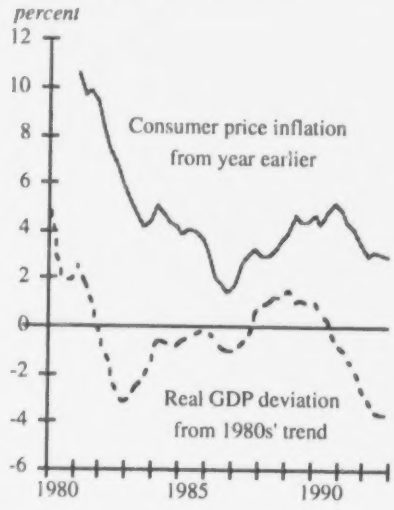
Completion of EMU is no foregone conclusion.

- In the short term, pre-EMU convergence aggravates Europe's economic sluggishness and unemployment, even as it curbs inflation.
- Defining a full operational structure for EMU will sharpen tensions.
- Economic and political friction could lead to back-sliding from the advertised schedule, while precipitate or poorly prepared narrowing of exchange rate bands could aggravate interest rate volatility.

Two implications for Europe's financial markets:

- Ongoing and careful progress toward EMU strengthens the chances for markedly lower European interest rates in coming years.
- Monetary integration — not necessarily a full-dress EMU — should help bond yield convergence across Europe. This may occur by fits and starts, but will proceed whether or not EMU ultimately prevails.

G-7 output gap and inflation



Global economic outlook

Until the U.S. economy comes back convincingly — unlikely before second-half 1992 — other G-7 countries will see slim growth pick-up.

- LDCs will enjoy little external support for growth this year; much of Latin America and Asia, however, can count on investor confidence and supply-side improvements for strong real GDP growth.
- Eventual G-7 recoveries will be mild — barely around potential *rates* of growth, and likely below in much of Europe.

Except in Japan, substantial shortfalls in activity below potential *levels* — "output gaps" — point to falling G-7 inflation into economic recovery.

- The falling dynamics, clearest for the United States and Canada, apply even to Germany beyond 1992's difficult wage round.
- The Federal Reserve is likely to keep short-term rates down amid low growth and inflation, the Bank of Japan to ease one more time. But the Bundesbank will stand firm through mid-year. Outside Japan, bond yields are headed for extended or renewed declines.

Contents

EMU off the Maastricht launchpad, 3
The benefits of EMU, 4
The costs of EMU, 6
The nature and scope of EMU, 7
From here to there, 11
The burden of convergence, 13
A more symmetric EMS?, 15
EMU and convergence, 17

Global economic outlook in summary, 18

Global economic outlook, 19
The Americas, 20
Europe, 22
Asia/Pacific, 24

Tables

Effective exchange rates, 26
Government Bond Index: performance and yields, 27

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EMU off the Maastricht launchpad

Table 1

The path to EMU

1988-date	• 1988 Hannover EC Summit commits to EMU in principle
	• Stage 1 of EMU begins, July 1990
	• Widening of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS)
	• Elimination of exchange controls (substantially completed, February 1992)
	• Progress to single financial market
By end 1992	• All national parliaments to ratify Maastricht Treaty
Jan 1993	• Single Financial Market to come into operation
Jan 1994	• Stage 2 of EMU to begin
	• European Monetary Institute (EMI) to open
By end 1996	• EMI to have established structure for European System of Central Banks (ECSB)
	• EMI and European Commission to report on achievement of convergence criteria to Heads of Government
	• Heads of Government to judge whether Stage 3 (and eventual EMU) is desirable and, if so, when
By end 1997	• If date not yet set, Stage 3 to start automatically on Jan 1, 1999

Principal author: Philip Suttle, J.P. Morgan, New York, who prepared this article while serving in London as Coordinator of European Economic Research.

At last December's Maastricht meeting of EC heads of government — and for the third time in the history of the Community — Europe launched on an elaborate course to monetary union (EMU) (see Table 1). Supposedly, the project will reach fruition by the end of the century, and perhaps see the ECU as Europe's single currency thereafter.

The benefits of EMU should be judged not by the obvious reduction in transactions costs, but instead by any reduction in business uncertainty; any kick from EMU to economic integration (with its potential gains for efficiency and macro-economic growth); and any success in maintaining durably low inflation. Meeting these objectives would improve Europe's longer-term economic performance. But EMU neither guarantees their delivery, nor is it the only conceivable monetary arrangement to these ends — witness the achievements of the current European Monetary System (EMS).

In fact, completion of EMU is no foregone conclusion. One obstacle is its long time horizon: near-revolutionary transformations now may be possible, even probable, in Europe, yet may not proceed literally by any pre-ordained schedule. The Maastricht program must jockey with other concerns now engulfing the EC: its probable enlargement within a few years to embrace some or all of Austria, Scandinavia, and Switzerland; and its relations with the impoverished formerly Socialist countries to the East, whose political instability occasions deep worry in the more settled West.

As important, EMU is not costless economically. Aside from one-time conversion costs, it reduces latitude in economic management. For small, largely open economies this latitude was never great — hence their enthusiasm for EMU. For the larger countries, intra-European exchange rate adjustment would be superfluous as a tool of policy if their economies were structurally well diversified, their labor and capital markets flexible, and their fiscal transfer system ample to shore up weak partners; none of these conditions currently holds.

Moreover, after 1994, defining the formal structure of a full EMU will sharpen tensions over its running. Among the issues: the nature of monetary control; the tolerance of large countries for simple-majority voting; intermediate objectives for the new central bank; and the balance among monetary, fiscal, and exchange rate policies.

More immediately, the trend toward EMU has two main implications for Europe's financial markets. First, though pre-EMU convergence efforts aggravate short-term economic sluggishness, they strengthen the chances for materially lower interest rates across Europe later this year. The transitional economic sacrifice makes timely completion of the "Single Market" program all the more important: an integrated European economy will make

EMU both more desirable and, potentially, less costly.

Second, ongoing monetary integration should foster convergence of bond yields, whether or not EMU ultimately prevails. To be sure, were EMU postponed or abandoned amid acrimony, convergence might falter or reverse. And, unless political commitment and market judgments are supportive, narrowing of exchange rate bands on a pre-fixed schedule could spawn destabilizing interest rate volatility. Assuming a modicum of goodwill and competence, however, the weight of economic and financial performance, momentum, and logic points along the general lines set out at Maastricht.

These first will erect a "two tier" EMU, in which countries able and inclined to keep step with Germany proceed expeditiously to union while others, with varying diligence, strive outside the first tier. But for the second tier countries, rational policies still would aim for closer monetary ties and generally stable exchange rates within Europe — conducive to convergence and consistent some day with a wider union.

The benefits of EMU

Europe's first effort toward monetary union fell victim to the 1973-74 oil price shock; the second, in the late 1970s, set up the EMS but then stalled. The third, initiated in 1988, is proving more resilient. Until almost the moment of Maastricht, those favoring greater European integration were winning over skeptics.

Different groups and countries want EMU for different reasons. Some seek further political integration of Europe. Others have a more limited purpose: to diminish Bundesbank hegemony over European monetary affairs and re-establish say over their own monetary policies, while retaining the gains in financial stability wrought by the current system.

The main economic benefits claimed for EMU — totaling upwards of 5% of GDP by possibly exaggerated European Commission estimate* — are savings in transactions costs, enhanced price transparency in the Single Market for goods and services, reduced exchange rate uncertainty, and entrenchment of low inflation throughout Europe.

Transactions savings are among the most tangible benefits of monetary union. For the corporate sector, the main savings probably accrue from reduced accounting and monitoring costs for payments, receipts, and exposures in 11 different EC currencies. The European Commission has estimated transactions cost savings within the EC of about ECU16 billion (0.3%-0.4% of EC GDP) (see Table 2) — useful, but hardly an overwhelming sum and one that would entail losses to providers of some financial services, notably exchange rate services, with larger benefits to the commercial and household sectors.

Table 2
EMU cost savings on transactions services
ECU billion

Financial transactions charges	8.2-13.1
Bank transfers	6.4-10.6
Banknotes and cheques	1.8-2.5
Users' in-house costs	3.6-4.8
Reduction in time cost of cross-border payments	1.3
Total	13.1-19.2

Source: "One market, one money," *European Economy* No. 44, European Commission, 1991.

* See pages 49-51 in *The Ecu Report*, M. Emerson and C. Huhne, European Commission, 1991. This estimate neglects the many gains available while retaining a system of national currencies.

EMU will increase price transparency across national borders. This will foster market integration, including at the retail level, and thereby amplify gains (and losses) from the Single Market program. Yet cross-border trade still will face language, culture, and other important barriers — indeed, late-1980s' cross-border brand euphoria has waned as companies have become more aware of national peculiarities of taste. Conceivably, monetary union will hinder completion of the Single Market: deprived of relief via devaluation, industries in weak areas of the Community may lobby for overt or covert protection to defend jobs; fortunately, protection will be harder to conceal in a price-transparent EMU.

The benefits to accrue from reduced exchange rate uncertainty are hard to quantify. In particular, it proves challenging empirically to demonstrate damage to economic performance from exchange rate variability as actually observed (the standard proxy for exchange rate uncertainty) — perhaps because the Exchange Rate Mechanism (ERM) already has successfully reduced exchange rate variability within Europe and, at least since 1987 (see Chart 1), has cut out the large, rapid intra-European exchange rate swings that are held to inhibit trade and international investment. Unless return to the large swings of the 1970s and early 1980s is the alternative, EMU may not greatly increase business certainty. Besides, businesses now can hedge against exchange rate uncertainty, admittedly at some expense, in increasingly liquid futures and options markets. Finally, though EMU can eradicate intra-European exchange rate uncertainty, it will leave businesses open to uncertainties over the key ECU-dollar and ECU-yen exchange rates — which for some are more problematic than intra-European relationships.

As for inflation reduction, EMU is not strictly necessary for low inflation in many parts of Europe: countries linking their currencies to the DM have achieved significant inflation reductions, especially in the traded-goods sector. In fact, for some, commitment to a fixed exchange rate — still more, to EMU — provides backbone to stiffen domestic discipline. For low inflation system-wide, the monetary anchor must enjoy a reputation for low inflation: still within reach for the DM, but less easy for an ECU under a novice supranational authority that lacks proven performance.

In weighing the gains from EMU, the case of Germany is particularly intriguing. It clearly has much to risk — its record, albeit tattered, of relatively low inflation; its low interest rates; and possible increasing fiscal payments to shore up weaker economies, much like today's transfers to the former East Germany. Germany can hope to gain economically from more transparent and stable markets in its EMU partners. Otherwise, its putative gains largely flow from the political aspirations of the current leadership to nest Germany irreversibly within a co-operative European framework. It is thus no surprise that Chancellor Kohl's failure to succeed in his aims for political union at Maastricht — to build, in effect, federal institutions

Chart 1

Intra-EMS exchange rate volatility*

*Mean of standard deviations over two years of month-to-month percentage changes in DM bilateral rates of the founder EMS currencies.

with a higher profile for the European parliament — makes many Germans suspect that they are giving all for nothing in return: opinion polls show as many as 80% against giving up the DM.

The costs of EMU

Aside from the one-time costs of converting one currency to another — printing new bank notes, establishing new payments systems, converting slot machines etc. — and the less short-lived psychological costs to the population in making the switch, the main costs of EMU are opportunity costs. In fixing their mutual exchange rates irrevocably, European countries will require other economic instruments and private-sector behavior to substitute for exchange rate adjustment — a low-cost sacrifice for EMU, however, if such adjustment is unnecessary or substantially ineffective for policy purposes.

Four features could make intra-European exchange rate changes superfluous: high labor and capital mobility within and between countries; low product or export specialization; a developed cross-regional fiscal transfer system; and a common rate of inflation.

If factor mobility within and between countries is sufficiently high, adjustment to "shocks" — say, in the form of a sudden decline in demand for a country's basic output or a sudden collapse in a key export price — benefits little by currency depreciation. Labor need not be perfectly mobile geographically, so long as wages are relatively sensitive to local labor-market conditions and capital is relatively mobile. In the European context, development of the Single Market in goods, services, labor, and capital thus is vital not only to boosting economic efficiency but also to making monetary union a success.

Low specialization also lessens the utility of exchange rate changes. True, it has not characterized all of Europe hitherto — to the contrary, the 1986 oil-price collapse forced both Norway and the United Kingdom to devalue, and Finland devalued under the more recent disruption of trade with the former USSR. The Single Market, however, inexorably fosters *intra*-industry trade across Europe along with dispersal of production steps across states long familiar in the United States.

In a single-currency area, devaluation cannot remedy regional weakness. Fiscal policy, however, can help through automatic stabilizers and discretionary action. Today, the EC's fiscal reach is very limited, unlike in fully federal monetary areas (see Chart 2). In Europe, national authorities will retain most taxation and spending powers unless and until there is a move to closer political union. Although it may be technically desirable to raise the EC's central resources, inter-country transfers are divisive politically, except perhaps in the most mature federations — to loud protest from the principal contributor countries, the EC Commission has just proposed a one-third real increase in spending through 1997, including a doubling of transfers to the four

Chart 2

Fiscal centralization

Central government outlays as percent of general government spending, 1987

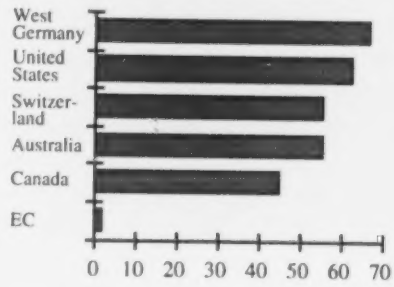


Chart 3

Services-sector price inflation

percent over year ago

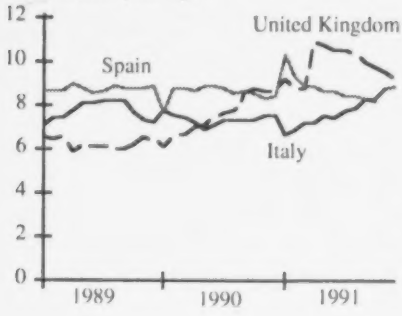


Table 3

Intra-EC economic openness, 1990

	Intra-EC trade, % of GDP	Population, million
Belgium	45	10
Ireland*	39	4
Netherlands	34	15
Portugal	25	10
Denmark**	14	5
Germany	14	79
Greece***	13	10
France	13	56
United Kingdom	11	57
Italy	10	58
Spain	9	39

* Until 1979, in effective currency union with the United Kingdom.
** Has traditional ties with other Nordic countries.
*** Geographically remote and late-joining member of the EC.

poorest members. Such transfers may even create moral hazard: economies have little incentive to control over-expansionary wage growth, say, if they can tap pooled financial resources — witness the somewhat extreme example of Eastern Germany and the fiscal demands from other quarters always pressing in on Germany.

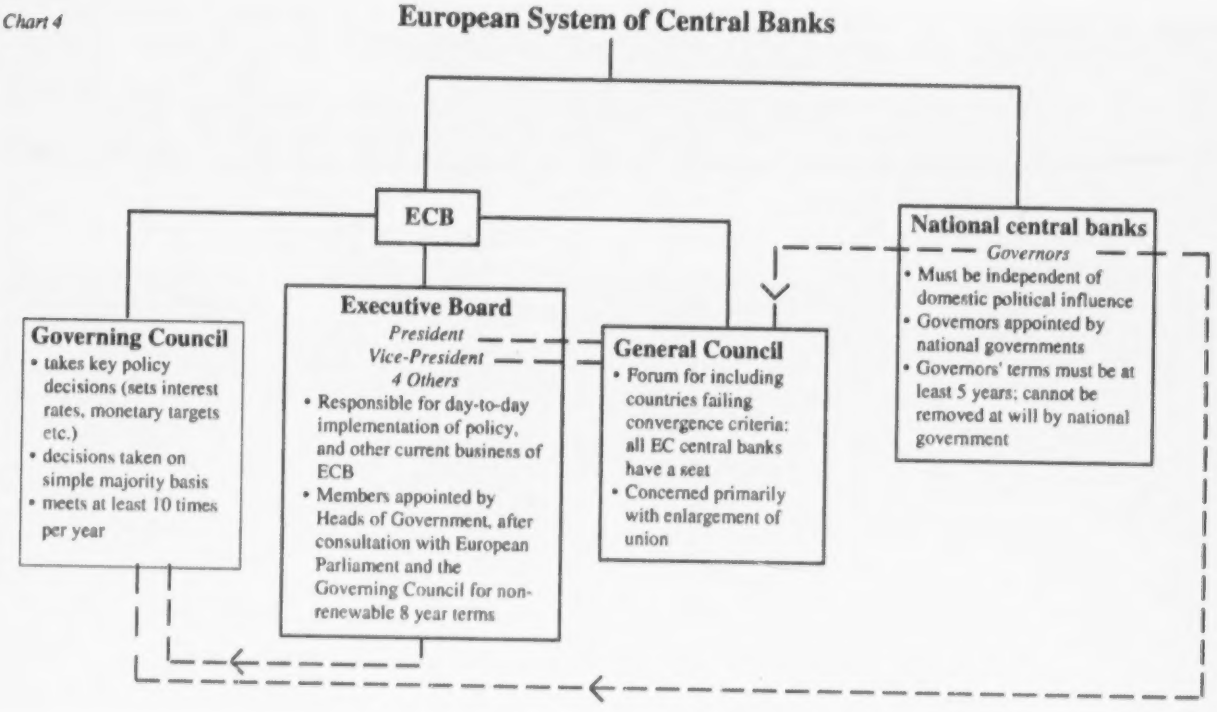
A common rate of inflation obviates one reason for nominal exchange rate change. By the same token, a period of exchange rate stability such as has been experienced in Europe tends to force inflation convergence, especially in goods markets where competitive pressures are most acute. If a monetary union is to hold with a degree of comfort, however, long-term underlying inflation *expectations and attitudes* must adjust to the same (in this case, low) level. This is clearly not the case of parts of the ERM at present: 4% inflation is viewed with alarm in Germany, but as a triumph in the United Kingdom. One fallacy is that low inflation is the result of an independent central bank. Independence certainly helps — and under the new EMU Treaty all countries must have at least ostensibly independent central banks by the start of Stage 3. But an independent central bank (like the Bundesbank) should really be seen as yet another manifestation of a country's appetite for low inflation and its politicians' willingness to accept this as a fact of life. Inflation expectations in Germany, Benelux, France, Denmark, and Ireland likely have fallen to the same low level. But they are higher in the United Kingdom, Italy, and Spain — witness the size of wage and price increases in the more sheltered, services sectors of their economies, increases not solely explained by more rapid productivity growth (see Chart 3).

Finally, the argument that intra-European exchange rate adjustment is ineffective, and thereby obsolete, has been commonly advanced in many European countries over the past ten years. Its premise is that higher domestic prices rapidly offset any effects of a nominal depreciation on the real exchange rate. The speed and extent of this response increases with economic openness: by the measure of intra-EC trade relative to GDP (see Table 3), the Netherlands, close to the economic center of gravity of Europe with a small land area and a population of just 15 million, is far more open than Germany, now with a population close to 80 million; with fewer political qualms than a neighboring small country, Denmark, the Netherlands is much keener than Germany to move to EMU at the earliest date.

The nature and scope of EMU

If most of Europe becomes a single monetary area before the end of the century, it will have unique characteristics. Most conspicuously, the ECU will become the only major currency issued by a supranational central bank. The draft statutes of the European System of Central Banks (ESCB) — written by the Committee of Governors of the EC central banks and attached as a protocol to the draft Treaty agreed at Maastricht — suggest that the ESCB will be a hybrid of the German Bundesbank and the U.S. Federal Reserve System. Like the

Chart 4


European System of Central Banks
ECB
National central banks
Governors
• Must be independent of domestic political influence
• Governors appointed by national governments
• Governors' terms must be at least 5 years; cannot be removed at will by national government
Executive Board
President
Vice-President
4 Others
• Responsible for day-to-day implementation of policy, and other current business of ECB
• Members appointed by Heads of Government, after consultation with European Parliament and the Governing Council for non-renewable 8 year terms
Governing Council
• takes key policy decisions (sets interest rates, monetary targets etc.)
• decisions taken on simple majority basis
• meets at least 10 times per year
General Council
• Forum for including countries failing convergence criteria: all EC central banks have a seat
• Concerned primarily with enlargement of union

former, the ESCB will have "price stability" as its main objective. Like both, it will have an explicitly federal structure, with the current central banks continuing as the local offices of the system. The two exemplars further inspire a new institution — the European Central Bank (ECB) — to serve as the heart of the EMU system (see Chart 4). Overall policy decisions — the setting of interest rates, monetary targets, and associated policies — are to be taken by the Governing Council of the ECB, consisting of the (currently 12) governors (or equivalent) of the member central banks plus the six members of the ECB Executive Board. The latter would run the day-to-day operations of the ESCB and the ECB, and would be headed by a President and Vice-President.

Many details of the structure and administration of the ESCB will remain vague for a time, until well after 1994 when EMI — the European Monetary Institute, whose main job is to create the ECB and ESCB — comes into operation. Aside from the legal character of the new institutions, several important issues await further discussion and resolution.

First, the Bank of England and the Bundesbank differ on whether the monetary control mechanism of the new system should include a minimum reserve requirement. The British substantially abandoned this approach years ago; they contend it would drive banking business offshore (disproportionately hurting London and Luxembourg) by functioning as a tax on activity — a fact well known to analysts of the U.S. banking scene. The Germans, hewing to their own

Table 4

Reserve requirements in the EC *

against commercial bank deposit liabilities (various, and not fully comparable, definitions)

	Percent
Germany	4.15-12.10
France	0.5-3.0
Italy	22.5-25.0
United Kingdom	0
Belgium	0
Netherlands**	0-50
Spain	5

* Reserves for monetary control purposes.
** Not operative at present; in theory, can be applied as a marginal cost penalty on bank *asset* expansion above a specified rate.

custom, believe reserve requirements necessary for proper monetary control. Eventually, a minimum reserve system is likely: the Bundesbank's more successful record in monetary targeting than the Bank of England's stands it in good stead; most other countries in Europe have minimum reserves (some higher than those in Germany — see Table 4); and minimum reserves on non-Ecu deposits could be interest-bearing or very low to keep Eurocurrency banking business in London.*

Second are voting procedures: under the current draft statutes, policy decisions would be taken by unweighted voting in the Governing Council of the ECB, with all key monetary policy decisions requiring a simple majority. This decision-making process — which gives the Director-General of the Luxembourg Monetary Institute the same power as the President of the Bundesbank — might be difficult for the larger economies in Europe to accept. The very low weight given to Germany — on paper only 6%, compared to a GNP weight of about 30% — also raises the risk of German wishes being over-turned by a more growth-oriented group.

The third is the objective basis — not to mention, focus — of policy decisions. The ECB's final objective of "price stability"** begs the choice of intermediate objectives. Normally, monetary authorities take decisions based on national variables. Major decisions of the Federal Reserve, for example, are taken wholly on the basis of national data. The Reserve is mindful of regional business conditions, as reflected in the monthly Beige Book presented to each FOMC meeting, but has long since realized the impossibility of differentiating its policy instruments and actions for regional ends. The ECB will likewise make policy based on macroeconomic performance over the whole monetary area; thus pan-Europe measures of ECU money supply, output, inflation, and the balance of payments will become prominent. Yet national statistical agencies are sure to publish their own country-specific aggregates (Eastern German aggregates, for example, are still available almost two years after monetary union). Tensions may arise when regional data point one way, but aggregates another.

The recent experience of Germany and the rest of Europe illustrates the problem. Late-1991 German indicators, especially rising inflation and accelerating money supply, prompted a further hike in the Bundesbank's key interest rates. Had the same individuals made their decisions based on pan-Europe data, they might well have eased policy inasmuch as basic performance trends in the rest of

* Also to be resolved are potentially difficult questions of day-to-day liquidity management (such as whether the ECB or the national central banks should be responsible for conducting open-market operations; whether all, and only, government paper should be used for such operations; and whether there should be a discount window and, if so, whether access should be controlled, especially at times of local financial difficulty) and lender-of-last-resort responsibilities.

** In practice, something like a 2% inflation rate in measured consumer prices or the GDP deflator, to accommodate under-adjustment for quality change in standard price indices.

Europe have diverged from Germany's since the fall of the Berlin Wall (see Charts 5, 6, and 7). Looking ahead, continued regional business cycle divergences may well lead to policy-making tensions — more than have affected the Federal Reserve in recent years because such regional disparities would reflect national disparities and also because the regional voice on the ECB (theoretically, 12 out of 18 votes) would outweigh the regional vote on the Federal Reserve's Open Market Committee (5 out of 12). Further potential for tension lies between the regions and the center, especially once the ECB becomes established and its President more visible. The importance of the ECB relative to national central banks was left deliberately vague in the Treaty, yet the squabble within Germany over Bundesbank restructuring underlines the difficulties even within one country.

Lastly, the relationship between the ECB's monetary policy and the overall fiscal and exchange rate stance of the EC is uncertain. The Treaty amendments impose elaborate mechanisms to deter individual countries from running excessive budget deficits. These criteria have two objectives (discussed further on pages 13-15): before union, to demonstrate a country's preparedness and willingness to follow responsible policies; and, following union, to prevent a country's public debt rising so sharply as would threaten its solvency. The purpose is to back up the "no bail-out" clause of the Treaty, by which neither the ECB nor any other Community institution is responsible for an individual country's debts. The Treaty makes no provision for the joint determination of fiscal and monetary policy. In all likelihood, the Governing Council of the ECB will have to take fiscal policy as given and, if necessary, take offsetting monetary measures. This considerably raises the scope for disagreement. Consider the situation where one or two countries adopt fiscal stimulus (possibly for political reasons). While this would undoubtedly raise the interest rate they would be forced to pay relative to other governments — a penalty that in mature federations may suffice to deter egregious behavior — it could also raise pressure for higher interest rates in the ECB Governing Council. The representatives of those regions or countries still practicing fiscal austerity might well object vigorously, especially if their own economies were seen as reaping slim spillover benefit.

The Treaty allocates the responsibility for exchange rate policy to EC Finance Ministers, leaving the ECB room only for consultation. This may be less of a contradiction than it seems: the U.S. Treasury is as responsible as the Federal Reserve for the dollar; and, under existing German arrangements, it is the Federal government that sets the broad parameters of exchange rate policy, including the DM's EMS parities. More generally, the larger the economic area the more domestic economic considerations weigh in the setting of economic policies, and the less of a consideration (and constraint) the exchange rate becomes. In consequence, external imbalances also play a reduced role in shaping pressures for currency movement.

Chart 5

Industrial production

1985=100

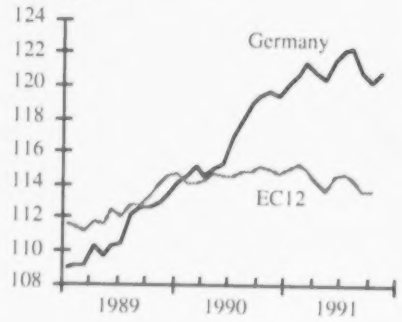


Chart 6

Unemployment

percent

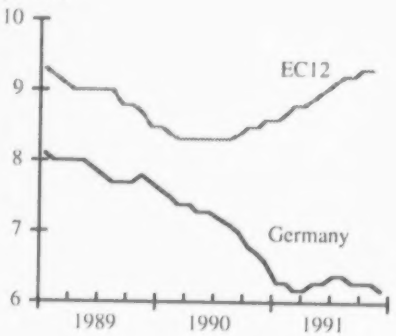
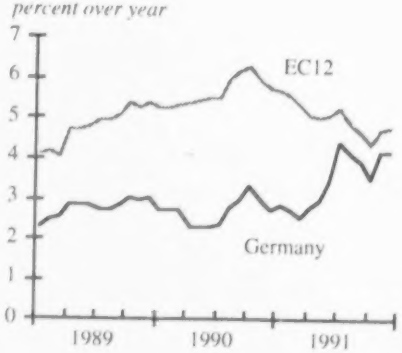


Chart 7

CPI inflation

percent over year



From here to there

Although the shape of the monetary union due in Stage 3 of the path to EMU will become an increasing focus through the 1990s, of more near-term relevance are the plans for the remainder of Stage 1 — which ends December 31, 1993 — and those of the succeeding Stage 2 — which is to last at least through end-1996 (see again Table 1). The next two years will be critical to the prospects for, and nature of, any eventual monetary union. They will bring important institutional changes and a series of European elections at which questions of European integration will figure large. There will also probably be a downturn in overall European interest rates as the Bundesbank shifts to less contractionary policy. But the most important work of the next two years will concern the extent to which aspiring members of the union conform to the stiff convergence criteria forming the test to be taken in Stage 2. To be in good shape to pass that test, every effort will need to be made to meet the criteria going into 1994.

This year, national legislatures have the responsibility of turning the Treaty amendments agreed by Heads of Government at Maastricht into national law. Failure to ratify the amendments unanimously would require their complete — and thus, non-trivial — renegotiation. Italian and U.K. elections could delay this process, but the greatest risks may be in Denmark and Germany. In Denmark, the constitution requires referenda on both political and monetary union, voting on the former being set for June 2. While its ratification seems likely, and the EMU vote will not take place until 1996 or 1997, a significant negative vote this year could check the government's enthusiasm for moving forward. In Germany, disappointment at Chancellor Kohl's failure to achieve closer political union has fueled opposition Social Democrat discontent. The opposition enjoys a majority in the upper house of parliament and could use this to block the legislation.

The other hurdle to be crossed this year is the choice of location of *both* the EMI and the ECB. As the EMI will develop into the ECB, the location of the EMI should ultimately decide the location of whatever central monetary authority emerges in Europe. London has a natural advantage as the largest existing financial market in Europe (indeed, in the world by some measures such as foreign exchange trading). Recently, the Bank of England has begun lobbying hard, partly from concern that choice of an alternative location could undermine London's leadership. Other obvious centers include Frankfurt and Paris. The most likely compromise candidate at the current time is Amsterdam. If this were chosen, the operating arm of the EMI/ECB could be at a national central bank in one (or more) of the more significant financial centres, much as the U.S. Federal Reserve's operating arm is in New York.

Three other specific institutional changes were set at Maastricht to occur before the end of 1993:

- An end to all exchange controls by all countries except Ireland, Portugal, and Greece (each

given extensions through 1996). This was accomplished when Spain lifted all remaining controls this February 1st.

- Central banks must stop lending to governments. Central banks still may hold claims on governments as a means to liquidity management of the financial system at large: government bonds and bills will remain the key assets on central banks' balance sheets and the basis for open-market operations. But government credit facilities at central banks will end, as will direct issues of government stocks to central banks — a significant strike for fiscal discipline.

- Aspiring first-round participants in EMU should be in the EMS narrow band. Although narrow-band membership is not strictly required by the end of 1993, it is very nearly implied: the convergence criteria require a country to have been a member of the "normal" fluctuation bands of the EMS for at least two years before the examination of suitability for membership, which is due to be conducted by the end of 1996 at the latest. Because examination could occur well before that date, narrow-band membership before December 1993 is a virtual certainty for Spain and the United Kingdom — most probably some time in the second half of 1992 when domestic considerations would also point to such a move.

In principle, these changes may increase interest rate volatility: exchange controls substitute to a degree for interest rate changes; a tighter exchange rate band involves more activist (two-way) interest rate adjustments; and ending central bank credit facilities requires governments to issue debt into markets in all circumstances. However, if the changes enjoy market credibility — as was broadly the case in January 1990 when the lira entered the EMS narrow band — the volatility impact may be minimal.

These steps toward EMU will proceed against a back-drop of dismally slow growth in the EC. Still, unlike in the period since EMU was re-launched in 1988, they will find support from likely easing of Germany monetary policy. Today, German short-term interest rates seem around their peak and market expectations have shifted dramatically. Since the last Bundesbank tightening in mid-December, long-term bond yields have dropped 30 basis points. Expectations have shifted amid signs of a stumbling economy in Western Germany: retail sales have slumped, manufacturing orders and output have slipped, inventories have risen sharply, and business confidence has fallen (see Chart 8).

Market expectations currently center on a modest easing in monetary policy through the second half of 1992 and into 1993. Expectations of how long this easing will continue are checked, however, by the consensus view that Western German growth will rebound as 1992 progresses, helped by the ending of the income tax surcharge in July and reviving

Chart 8

German manufacturing

latest 3 months, percent change over year ago

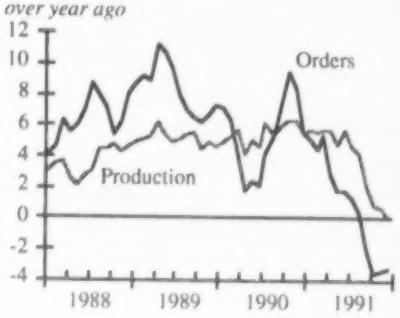


Table 5

Convergence criteria defined

To be eligible for EMU, a country must meet 4 criteria:

- In the year before examination, the member's *average CPI inflation* rate must not have exceeded that of the three best performing members by more than *1 1/2 percentage points.*
- At the time ofexamination, the country must not be the subject of a Council decision that an *excessive deficit* exists for that member. An excessive deficit can exist if:
  - the budget deficit exceeds 3% of GDP with no real sign of improvement;
  - the ratio of debt to GDP exceeds 60% and is not falling sufficiently rapidly.
  Additionally, the decision will take into account the level of government investment spending and the medium-term budgetary position of the member;
- The member must have observed the *normal bands of fluctuation in the EMS* without severe tension for at least two years before the examination;
- In the year before the examination, its *average long-term bond yield* should not exceed that of the three best performing members by more than *2 percentage points.*

export markets. Yet this rapid playing out of the business cycle in Germany seems far too sanguine in light of the prospective January 1993 VAT hike in Germany — and more especially of recent cyclical experience in other major economies, where recovery in activity has to date been delayed even though the process of monetary easing is quite advanced. Granted, the German economy has not experienced the same construction, corporate, or consumer borrowing excesses that are holding back growth in the Anglo-Saxon economies, but it has developed its own difficulties that will retard growth.

First, the 1990-91 budget-deficit widening has paralleled the early-1980s' expansion. From 1983 through 1987, sustained fiscal restraint held back domestic demand growth, and a similar influence is likely to prevail over the next few years. Second, business capital spending has expanded rapidly in the past three years, fueled by strong demand, high capacity utilization rates, and rising profitability. All these positives now having reversed, investment has stalled. In view of the current high level of the DM and domestic wage increases, and the now more-plentiful availability of low-wage investment alternatives outside Germany, the prospects are for a sustained period of investment weakness.

The question is whether this new environment — in which Bundesbank policy comes to be seen as much less of a constraint by other countries — will stifle the pressure for monetary union. The answer is probably negative: some may find EMU more acceptable if pressures from Germany abate. Moreover, after considerable efforts and attendant pain to meet the convergence criteria, many countries will be reluctant to give up on EMU.

The burden of convergence

In the next two years, the convergence criteria established at Maastricht will be key to judging whether a union will be created before the end of the century and which countries will be part of it. The criteria — covering inflation, bond yields, budget deficits, public debt, and exchange rate stability — are defined more precisely than expected at the outset of 1990-91's Inter-governmental conference on EMU; still, there is much scope for judgment in applying the fiscal criteria (see Tables 5 and 6).

There are two striking features about the convergence criteria. First, it is notable how few coun-

Table 6

Convergence criteria applied to 1992

J.P. Morgan estimates

		Percent of GDP				
	Inflation	Public Deficit*	Public Debt*	Bond yield**	Narrow band participant	Country score
France	3.1	1.4	47.7	8.2	Yes	5
Denmark	2.5	4.0	59.8	8.3	Yes	4
Germany	3.5	4.4	46.5	7.7	Yes	4
Netherlands	4.0	3.9	80.3	8.1	Yes	3
Belgium	3.2	5.6	132.0	8.5	Yes	3
Ireland	3.0	4.0	109.5	8.6	Yes	3
Spain	6.5	2.0	46.3	10.2	No	3
United Kingdom	4.5	4.4	38.4	9.0	No	2
Italy	5.5	9.5	105.5	12.0	Yes	1
Portugal	9.5	6.5	70.0	15.0	No	0
Greece	15.0	17.0	86.9	n.a.	No	0
Criteria thresholds	4.4	3.0	60.0	10.4	Yes	
EC 12 score per criterion	6	2	5	7	7	

* General government basis (central, state, and local authorities plus non-commercial public entities).
** 10-year governments or nearest available long-term maturities.

tries actually meet the criteria at present. Today, only France among the major economies would meet the full set (Luxembourg, with a population of just 375,000, would also qualify). This is due partly to Europe's current economic weakness, which has increased budget deficits. That weakness, however, has been critical in reducing inflation rates to within the 1.5 percentage point margin permitted over the lowest three rates among EMS members. It remains to be seen whether today's good inflation performance throughout Europe is consistent with subsequent growth anywhere near potential: any revival in growth could quite quickly lead countries to fail the inflation test, at a time when German inflation (excluding any tax effects) is likely to be dropping below 3%. One way or another, the criteria are set to keep monetary and fiscal policies more austere than they might otherwise be, thereby restraining growth. This is as true of Germany as the other countries. The fiscal burden appears particularly severe. Most European countries have quietly eased fiscal policy a little in the past year. But if the Maastricht criteria are to be met by the mid-1990s, overall European fiscal policy will need "discretionary" tightening by at least 0.5% of GDP *annually* for the next four years. Whether or not this restrictiveness is eventually successful, it is a recipe for slow growth.

Second, the criteria are quite different from those considered above as to whether it makes economic sense to form a monetary union — none, for instance, focuses on the technical issues of factor mobility or the degree of openness, let alone fundamental considerations such as growth and employment. The condition of exchange rate stability "without severe tensions" (a term nowhere defined) can be thought of as a catch-all indicator of suitability for EMU; the two-year period which this test will appraise, however, is a relatively short length of time to judge suitability for permanent fixing. The other conditions serve two policy purposes: to show that each country has a similar appetite for inflation; and to convince the skeptical German authorities that their partners are serious.

The convergence criteria also pay little attention to whether the current *level* of intra-European nominal exchange rates makes sense, or instead warrants "one last realignment."* By focusing on keeping inflation differentials low, the Treaty takes an implicit view that current real exchange rates are just about right. Judging the appropriateness of a particular real

Table 7
Indicators of exchange rate sustainability

	Wage levels, % of EC average*	Real exchange rate, 1991 Dec, % diff. from 1980s' average	Current account balance 1990-92, % of GDP
Germany	132	2.4	0.4
France	85	2.2	-2.5
Italy	91	3.3	-1.4
United Kingdom	85	3.7	-1.7
Belgium	106	-5.3	2.3
Denmark	143	2.7	1.5
Greece	60	-0.7	-3.5
Ireland	83	3.2	2.9
Netherlands	120	8.0	3.9
Portugal	46	-16.2	-1.0
Spain	76	14.0	-3.2

* U.S. Bureau of Labor Statistics estimates of hourly compensation in manufacturing (in dollars) per unit of GDP per employed person (GDP evaluated at EC Commission estimates of relative currency purchasing power).

* The notion of one last realignment is not necessarily inconsistent with monetary union. Just ahead of union, current market exchange rates could well be out of line with fundamentals, requiring relative wages and prices in some countries in the union to go through a major post-union correction. Even with fluid factor markets etc., this adjustment could be unnecessarily painful while the option of exchange rate change still exists. But this one time last adjustment could (by definition) occur only on the eve of EMU. It would, for example, be impossible (even if desirable) to convince financial markets that the last realignment before EMU in 1997 would occur in 1992. One last realignment could also be useful in "rounding off" existing currencies against the ECU (e.g. making the DM/ECU rate 2 to 1 rather than the current 2.04) to allow more straightforward conversion of local currencies into ECU.

Chart 9

Unit labor costs relative to Germany

1985=100

exchange rate is inevitably somewhat arbitrary. One test is whether the real rate is significantly out of line with the long-run average (see Table 7), or whether unit labor costs have moved sharply out of line with those in Germany (see Chart 9). A second is whether productivity-adjusted *levels* of labor costs are broadly equivalent. A third is whether the current account is significantly away from balance. On all these criteria, it is difficult to identify currencies of existing members of the EMS as grossly under- or over-valued on fundamental grounds. In particular, it is difficult to make a case — even after five years of no realignment — for revaluation of the DM. Spain, for example, has seen rapid wage-cost deterioration relative to Germany in recent years plus the emergence of a wide current account deficit, and is seen by some as a candidate for depreciation. Wages in Spain remain low relative to other parts of Europe, however, and the process of European integration was always bound both to raise wage costs in Spain relative to other parts of Europe and push the current account into deficit as the counterpart to the substantial inflow of foreign capital. Similarly, British wages are low relative to Germany's and erosion of U.K. competitiveness in recent years needs to be viewed in the context of the major gains of 1985-86.

A more symmetric EMS?

Enough doubts attend the viability of the current EMU project that alternatives need to be considered.

The most extreme is that not only monetary union, but also monetary integration, will fall apart. This, however, would take a major reversal of policy attitudes internally in Europe.* Foreseeable national shifts in governing parties and coalitions do not point to such a reversal, notwithstanding the new political challenges facing Europe.

Two more plausible scenarios are that the existing EMS system lives on, perhaps with ever narrower bands of actual exchange rate fluctuation; or that a limited EMU emerges, made up of the 7 long-time members of the DM block (Germany, the Netherlands, Belgium, Luxembourg, Denmark, France, and Ireland) — leaving open the fate of countries left out.

When the EMS began, it was expected to develop into something more than a mere exchange rate mechanism. But if it ever becomes clear that the political appetite for EMU has diminished, there is no *technical* reason why the exchange rate mechanism cannot survive unscathed. Obviously, the circumstances of EMU failure or abandonment would affect the EMS; but, if reached without rancor, a mutual agreement that EMU was not necessary could conceivably leave the EMS stable and intact.

Further, it is not obvious that the Bundesbank's dominance over the system will persist in the years ahead. Its reputation is not immu-

* The ability of external economic shocks to wreak havoc on the EMS appears to have faded — it is difficult to come up with a new external shock that the EMS has not faced and survived in the past three years, let alone its baptism at the end of the 1970s amid the second OPEC oil shock.

table — it has been earned through a decades-long record of maintaining a uniquely low rate of inflation. As a result, throughout most of EMS history the DM has been viewed as a one-way bet against other European currencies. In the next few years, two developments could change this perspective. First, Germany's inflation uniqueness could be lost as a permanent, and not just a temporary, phenomenon. Second, growth in Western Germany could significantly underperform growth elsewhere in Europe. Western Germany will be weighed down by fiscal adjustment and recent losses in competitiveness, while other European economies should be in a recovery period. This will be no mere cyclical development, being reflective more of the structural difficulties facing Germany after unification. With no superior inflation performance, an inferior growth performance, and possibly a persistent (but small) current account deficit, German hegemony may fade and the EMS become — at least for the major countries — a far more symmetric arrangement.

The Treaty sets out a minimum requirement that a majority of EC members — currently 7 — must meet the convergence criteria for union to be considered after the first inspection, although a more limited union will come into effect in 1999 encompassing countries that meet the criteria. It seems inevitable that Greece and Portugal will not meet the criteria before 1997, but it is also probable by that time that the EC will have more members — at least Austria and Sweden, whose recent applications are likely to lead to entry in 1995 — who would probably meet the criteria at once. The Bundesbank would have fewer qualms about monetary union with countries effectively in the DM block.

Those countries not eligible to join in Stage 3 — "countries with a derogation" — would essentially remain members of a shrunken EMS, dominated by the ECU. At the current time, the countries most likely to fit this category are Spain, the United Kingdom and, especially, Italy — which is furthest among serious aspirants from meeting the criteria. If these countries fail to make the first round, their subsequent performance will be reviewed for later potential membership. In principle, countries aspiring to EMU will avoid the stigma of failure at the first cut. In the meantime, they will be able to participate only in token activities of the ECB as members of the General (but not the key Governing) Council.

Whether these ideas can be operated easily in practice is another matter. One risk is that financial markets will see failure to meet the criteria as such a sign of fundamental weakness as to precipitate substantial capital outflows — perhaps so overwhelming as to require reimposition of capital controls or realignment against the ECU; either outcome would highlight further that country's isolation. Alternatively, remaining independent from the ECU and periodically devaluing could undermine domestic discipline, either in the labor market — where wage inflation would accelerate — or in fiscal policy — where, especially in the case of Italy, the

Table 8

Government bond spreads and risks

10-year maturities, basis points, annualized

	Actual Spread	Credit and liquidity risk*	Foreign exchange risk**
France	60	0	60
United Kingdom	170	20	150
Italy	480	50	430
Spain	290	50	240
Denmark	65	40	25
Belgium	80	50	30
Netherlands	45	40	5

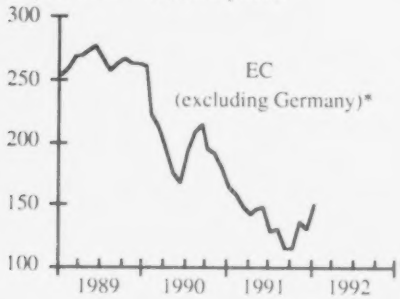
* Assessments based on observed Euromarket spreads on bonds issued in a common currency; a rough allowance for public-sector debt ratios; and a somewhat subjective allowance for traders' judgment of liquidity.

** Probably conservative relative to indications derived from the swaps markets.

Chart 10

Government bond yield spreads over Germany

10-year maturities, basis points



*Average of Belgium, France, Denmark, Italy, Netherlands, and the United Kingdom.

Chart 11

ECU yield spread

actual less theoretical, 10-year government bonds, basis points

fiscal requirements of EMU are seen as virtually the last way of forcing politicians to square up to cutting the budget deficit.

EMU and convergence

The EMU process will affect money and fixed income markets in two key ways in the next few years. First, as noted, the deflationary macroeconomic policies likely in countries aspiring to EMU will add to pressures lowering nominal and real interest rates across Europe. Second, EMU's progress has implications for the relative performance of European markets and their yield convergence.

Steady moves to EMU will further hasten yield convergence: with a single currency, differences in government debt yields will reflect only credit risks and liquidity, rather than the substantial currency risk that remains the main factor behind the current yield spreads over Germany of Italy, France, the United Kingdom, and Spain (see Table 8). Yield convergence has reversed slightly in recent months, largely because the increase in German official interest rates and the strengthening in the DM have raised concerns over an EMS realignment (see Chart 10).

Signs that countries are failing to meet the convergence criteria could stall progress on yield convergence for a time, but not ultimately prevent it. So long as fundamental performance in economies around Germany — especially, but not exclusively, inflation — continues to match or outperform that in Germany, a case can be made for exchange rate stability — and this is the key ingredient to low spreads. Furthermore, German unification has led to a marked worsening in the prospective German public-sector debt-GNP ratio in coming years,* and has damaged Germany's prospective creditworthiness vis-à-vis other major European economies — an effect still probably underpriced in financial markets.

The ECU market is most sensitive to news on EMU. ECU yields remain significantly beneath their theoretical levels, reflecting partly transactions cost savings relative to those of matching the ECU basket in individual currencies and, more importantly, an anticipation that the Ecu will become the lowest yielding market in Europe in five years time (see Chart 11). This differential — currently 60 basis points — would largely disappear if EMU appeared unlikely to occur.

The Maastricht agreement allows the EMU process to move ahead, explicitly putting European monetary arrangements within an EC framework for the first time. At the current time, it is impossible to judge with confidence whether the path mapped to EMU will be followed. After all, there are a considerable number of economic, let alone political, obstacles right now to the replacement of national currencies. At the very least, these will ensure that the EMU debate becomes more active and heated as the 1990s progress.

* See "East Germany's integration with the West," *World Financial Markets*, September/October 1991.

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Global economic outlook in summary

percent change from previous year, except as noted; group averages and totals are for countries listed

	Nominal GDP/GNP	Real GDP/GNP			Consumer prices Dec-Dec			Current account					
	$ billions, 1990							$ billions			% of GDP/GNP		
		1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992
Industrial countries	15965	2.5	0.9	1.0	5.2	3.6	3.0	-90.2	-15.3	-23.8	-0.6	-0.3	-0.3
United States	5465	1.0	-0.7	0.3	6.2	3.0	2.8	-92.1	-4.4	-28.5	-1.7	-0.1	-0.5
Japan	2958	5.2	4.4	2.7	3.5	3.2	2.2	35.8	72.6	75.3	1.2	2.1	2.0
Canada	575	0.5	-1.1	1.0	5.0	3.8	2.9	-19.0	-21.8	-19.2	-3.3	-3.7	-3.2
Australia	507	1.7	-2.1	1.2	6.9	1.6	3.4	-14.5	-11.6	-11.3	-4.8	-3.7	-3.7
Western Europe	6460	2.8	1.0	0.9	5.1	4.5	3.8	-0.4	-50.1	-40.1	-0.1	-0.9	-0.6
Germany	1518	4.7	3.1	0.0	2.8	4.2	2.5	44.7	-19.3	-8.3	2.9	-2.2	-0.8
France	1197	2.8	1.2	1.4	3.4	3.1	3.0	-8.4	-5.3	-4.9	-0.7	-0.5	-0.4
Italy	1105	2.0	1.1	1.3	6.4	6.0	5.3	-14.4	-16.0	-18.0	-1.3	-1.4	-1.6
United Kingdom	848	0.8	-2.4	0.7	9.3	4.5	4.5	-24.6	-10.5	-7.1	-3.0	-1.2	-0.9
Belgium	197	3.4	1.7	1.6	3.5	2.8	3.2	5.0	3.7	2.5	2.5	1.8	1.3
Denmark	130	1.6	1.0	1.5	1.9	2.5	2.5	1.5	2.2	1.3	1.2	1.6	1.0
Finland	138	0.0	-6.0	-2.0	5.3	3.9	4.8	-6.7	-6.1	-4.1	-4.9	-4.2	-3.5
Netherlands	276	3.4	1.8	1.0	2.6	4.9	3.7	9.9	8.7	7.9	3.6	3.1	2.9
Norway	106	1.8	2.5	2.4	4.5	3.5	3.5	3.6	4.2	3.7	3.4	4.1	4.1
Spain	488	3.6	2.6	2.7	6.5	5.6	5.7	-15.7	-17.3	-18.6	-3.6	-3.2	-3.3
Sweden	227	0.3	-1.5	-1.0	10.8	7.9	3.0	-5.4	-4.9	-4.6	-2.4	-1.5	-1.1
Switzerland	230	2.6	-0.3	0.5	5.3	5.0	3.5	10.1	10.5	10.1	3.8	4.5	4.6
Emerging markets													
Latin America	938	-1.2	2.9	1.6	1038	280.0	201.4	0.5	-15.3	-24.4	0.1	-1.4	-1.9
Argentina	103	0.4	5.0	5.5	1344	84.0	15.0	1.8	-2.9	-4.0	1.7	-2.1	-2.6
Brazil	521	-4.6	0.8	-0.5	1585	475.1	350.0	-2.2	-2.1	-0.5	-0.4	-0.5	-0.1
Chile	28	2.1	5.7	5.3	27.3	18.7	20.0	-0.8	-0.3	-1.5	-2.8	-1.0	-4.3
Mexico	238	3.9	4.9	3.5	29.9	18.8	12.6	-6.3	-11.1	-16.5	-2.6	-3.9	-5.0
Venezuela	48	5.7	9.2	5.0	36.5	31.0	31.0	8.0	1.1	-1.9	16.7	2.0	-3.2
Asia/Pacific	707	7.2	6.9	6.7	8.0	7.7	7.2	5.1	-7.7	-15.0	0.7	-0.9	-1.6
Hong Kong	70	2.4	3.8	5.5	11.3	10.3	10.0	8.9	7.0	4.5	12.6	8.5	4.7
Indonesia	104	7.4	6.0	5.5	9.5	10.0	8.5	-3.3	-4.3	-4.3	-3.1	-3.6	-3.3
Korea	238	9.0	9.0	7.5	9.4	9.6	9.2	-2.2	-10.0	-8.6	-0.9	-3.7	-2.8
Malaysia	43	9.8	8.5	7.0	4.1	4.2	4.8	-1.7	-4.3	-5.3	-4.0	-9.0	-9.6
Philippines	44	3.7	0.0	2.5	14.2	12.4	9.5	-2.7	-1.1	-1.4	-6.1	-2.5	-2.7
Singapore	36	8.3	6.5	5.7	3.8	2.9	3.2	2.4	2.8	0.6	6.7	7.0	1.2
Taiwan	162	5.3	7.0	7.5	4.6	4.4	4.0	10.8	10.5	7.8	6.7	5.8	3.8
Thailand	80	10.0	7.9	7.5	6.6	4.7	5.2	-7.1	-8.3	-8.3	-8.8	-9.1	-8.3

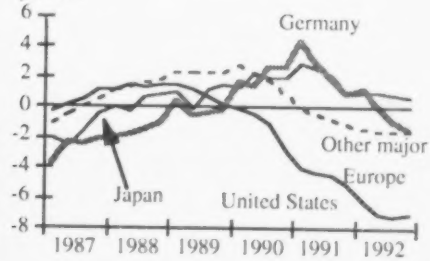
	Real GDP/GNP contributions, %						Private consumption			Business fixed investment			Budget balance* % of GDP/GNP		
	Domestic demand			Net exports change											
	1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992
G-7 industrial countries	2.4	0.4	0.9	0.2	0.6	0.2	2.3	0.9	1.3	4.1	1.0	-0.4	-2.0	-2.6	-3.1
United States	0.5	-1.4	-0.1	0.5	0.7	0.4	0.8	-0.1	0.6	0.1	-0.7	-0.6	-2.5	-3.0	-4.3
Japan	5.2	3.2	2.3	-0.2	1.2	0.4	4.2	2.7	2.6	12.4	6.2	1.3	2.7	2.6	2.5
Canada	0.6	-1.0	1.0	0.8	-0.1	-0.3	1.3	-1.0	1.1	-3.2	-4.2	-4.8	-4.0	-4.5	-5.9
Europe (4)	3.0	0.9	1.1	-0.1	0.2	-0.1	2.9	1.3	1.2	4.5	0.5	-0.6	-4.2	-5.1	-4.9
Germany	5.1	2.8	0.0	-0.4	0.3	0.0	4.1	2.4	0.0	9.3	10.1	-2.0	-3.7	-5.0	-4.4
France	3.3	1.2	1.4	-0.4	0.0	0.0	3.1	1.6	1.6	5.4	-2.4	0.1	-1.4	-1.5	-1.2
Italy	2.0	1.1	2.2	0.0	-0.3	-0.4	2.7	1.8	2.5	2.1	-0.8	1.5	-11.3	-11.1	-9.5
United Kingdom	0.1	-3.1	1.0	1.0	0.8	-0.3	1.0	-1.9	1.0	-2.2	-11.1	-1.8	0.4	-2.8	-5.0

* General government definition (central, state, and local authorities plus noncommercial public-sector entities) for United States, Japan, and Canada; preferred national definitions for European countries.

Global economic outlook

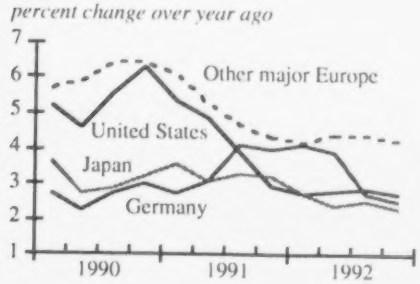
Output gaps

real GDP deviation from 1980s' trend, percent



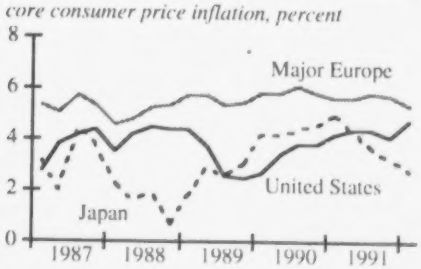
CPI inflation outlook

percent change over year ago



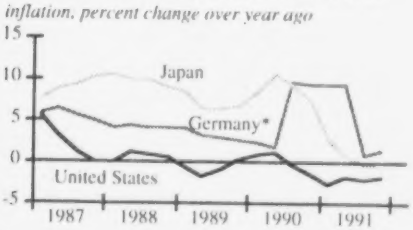
Real government bond yields

10-year nominal yields adjusted for year-ahead core consumer price inflation, percent



Real money supply

broad measure adjusted for core consumer price inflation, percent change over year ago



* Calculated from M3 level for United Germany, 1991Q1-1992 Jan; prior level taken as West German M3 plus 7% to adjust roughly for unification.

Economic recovery. January's gains in U.S. housing starts and retail sales do not signify an early spring for overall economic activity in the United States, still less worldwide.

- Until the U.S. economy comes back convincingly — probably not before the second half of 1992 — no material pick-up in real GDP growth rates will emerge in other G-7 countries (either in year-on-year terms or quarter-to-quarter, abstracting from seasonal distortions).
- In turn, LDCs will enjoy little external demand support for their growth this year; much of Latin America and Asia, however, can count on investor confidence and supply-side improvements to sustain strong real GDP expansion.
- G-7 fiscal policies are not assertively expansionary anywhere, except in the United Kingdom. And, except in Japan, long-term interest rates today are no lower in *real* terms than during the late 1980s' boom.
- In consequence, G-7 recoveries will be mild — barely around potential *rates* of growth, and quite likely below in much of Europe.
- Output gaps — shortfalls in activity below potential *levels* — are continuing to widen in North America and the United Kingdom, spelling job losses and worker discouragement adverse to confidence.

Inflation. Except in Japan, where output if anything still runs above potential, slack G-7 labor markets and excess production capacity point to moderating wage behavior and keen goods and services pricing ahead; this implies falling inflation into the economic recovery phase.

- The falling dynamics are clearest for the United States and Canada, and will keep U.K. core inflation converging on DM bloc levels.
- The same dynamics are coming into play this year in Germany, though union recalcitrance makes for a difficult wage round.
- Most commodity prices will stay depressed for the foreseeable future absent special supply situations. In particular, no oil price recovery beckons, given also that OPEC lacks credibility on curbing output.

Interest rates. The logic of low growth and inflation argues for extended or renewed declines in global bond yields during 1992 (apart from Japan).

- U.S. markets have sharply reversed in recent weeks on mere gleams of economic life to come, perhaps aggravated by M1/M2 growth; yet a surge of a few weeks' or months' duration does not undo several years' below-target growth of U.S. M2 or its stagnation in real terms (the latter phenomenon is seen also in Japan).
- The Federal Reserve is likely to keep short-term rates low and the Bank of Japan to ease one more time.
- The Bundesbank stands firm against above-target M3 growth and domestic indiscipline — an unavoidable stance through mid-year while the wage round drags on. Monetary policies across Europe will stay commensurately taut, but could then ease smartly to buoy growth.

The Americas

United States. After a 2% slide in the current quarter, propelled by late-1991 inventory pile-up, a gradual revival of *overall* activity is likely later in 1992.

- Until the inventory cycle turns, production and jobs are falling; this bodes poorly for consumption and worse for business investment..
- Housing's tonic for recovery is present, but feeble by past standards. Net exports are a plus too, but not strongly so in a sluggish world.

Inflation is falling. The CPI is up only 2 1/2% over the past year thanks to weak food and oil prices; "core" inflation will be down to 3% by year-end. Contrary to the consensus' 4%-5% long-term inflation view, excess capacity and high unemployment will hold the rate low far into 1993 or beyond.

- Job losses, atypically widespread across status and sector lines, are depressing wage expectations across the board.

History does *not* point reliably to higher interest rates at the first hint of recovery. In a slow recovery, low inflation, environment, short-term interest rates are likely to continue low.

- Long-term interest rates, after January's escalation, are high in real terms; in this light, the fall in nominal rates to date since last summer promises no quick or potent economic stimulus.

Canada's bleak economic outlook mirrors the protracted U.S. recession. The comfort is that this offers at least comparably sustained low inflation.

Latin America. Poor world export markets and low commodity prices will widen current account deficits in the region this year, but investor enthusiasm makes financing easy for the time being. Indeed, as structural reforms boost supply, real GDP growth in the five major countries (apart from Brazil) may suffer surprisingly little relative to 1991's 5.2%.

- Worries center on Brazil's stabilization and reform tribulations and on oil exporters, such as Mexico and Venezelua, for whom low oil prices portend fast-rising debt once again (and, for the latter, political strain).

United States: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991		1992			Q4/Q4 change	
	1991f	1992f	Q4	Q1f	Q2f	Q3f	Q4f	1991f	1992f
Real GDP	-0.7	0.3	0.3	-2.0	0.0	2.0	3.5	0.2	0.9
Private consumption	-0.2	0.9	-1.1	0.3	1.1	1.8	3.0	0.3	1.6
Business fixed investment	-6.6	-5.7	-2.4	-11.4	-8.6	-0.3	-0.3	-6.9	-5.3
Residential construction	-10.4	8.9	10.6	9.8	5.6	9.3	12.2	-1.3	9.2
Inventories*	-0.3	0.0	0.2	-2.0	-0.2	0.8	1.3	0.7	0.0
Net exports*	0.7	0.4	1.9	0.4	0.7	0.2	-0.1	0.5	0.3
Consumer prices	4.2	2.9	3.6	2.5	2.9	3.0	2.9	3.0	2.8
Civilian unemployment rate (%)	6.8	7.5	7.0	7.3	7.5	7.7	7.5		
Trade balance FAS/CVB ($bil.)	-66	-48	-62	-54	-46	-44	-48		
Current account ($bil.)	-4	-28	-30	-35	-28	-24	-27		

* Percentage-point contributions to real GDP growth.

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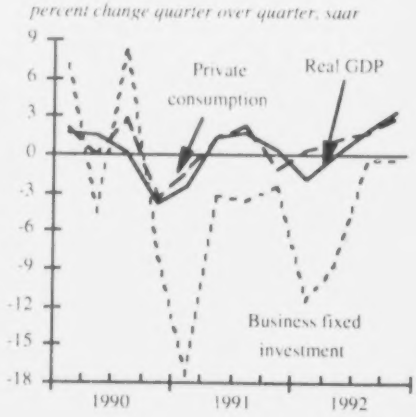
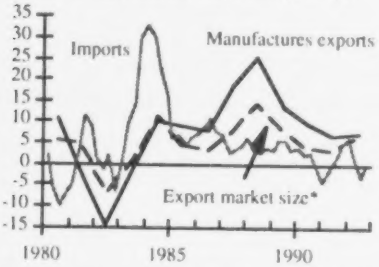
U.S. recovery profile

percent change quarter over quarter, saar



U.S. trade performance

volume terms, percent change over year ago



*OECD estimates of imports into major foreign markets, weighted by U.S. exports.

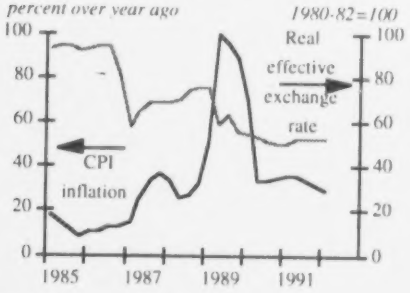
U.S. exports

merchandise, billions of dollars at annual rates

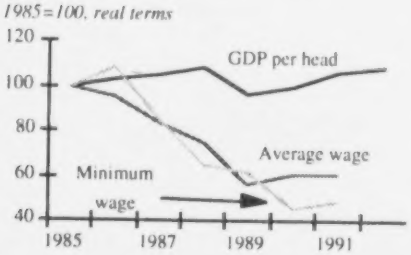
		avg. % change from year earlier			
	$bil. 1991	1980-1985	1986-1990	1991	1992Q4
Total	421.9	2.8	16.1	7.2	4.1
Volume		-0.1	12.9	7.9	3.0
Price		2.7	2.8	-0.6	1.1
Western Europe	118.7	0.6	19.8	5.0	0.0
Canada	85.1	7.2	10.2	1.7	3.0
Japan	48.1	4.3	23.3	-0.9	3.0
4 Asian NICs	45.7	7.3	29.2	12.1	6.0
China	6.3	20.4	4.9	30.8	18.0
Mexico	33.3	5.8	22.0	17.7	14.0
OPEC	19.1	-3.6	3.5	39.3	-15.0
Other Latin America	21.0	-0.4	12.2	21.0	15.0
Other	44.7	2.1	14.1	2.7	9.0

Venezuela: inflation, real exchange rate, and income per head

percent over year ago *1980-82=100*



1985=100, real terms



U.S. trade: a bright spot in tough times

Sparkling net exports saved the U.S. economy from contraction in the final quarter of 1991. Trade momentum will continue to prop up overall activity through most of 1992 and also shrink the trade deficit to $50 billion or below for the year as a whole — less than one-third 1987's red ink and the least in ten years.

Until domestic inventories shift to recovery, non-oil import volumes are set to slide. They will come back once domestic demand picks up, but could still run below recent levels toward year-end even if they grow, quarter-to-quarter, on the order of 8% annualized by that time. The anticipated mildness of domestic recovery, along with a dollar barely above its lows of early 1991 in real effective terms, virtually assures that the 20% annual growth in import volumes during the first two years of the 1980s' domestic expansion will not be repeated.

More fundamentally promising is the continuing strength of U.S. exports. To be sure, the heady 16% annual value gains of 1987-90 were not sustained as the effects of the dollar's come-down from its mid-decade overvaluation began to ebb and as world-trade volume gains retreated from a 1988 high of 9%. Yet U.S. manufactures exports still rose 8% in 1991 amid slim growth of imports into U.S. export markets. Crucial to this result have been the slim 7% cumulative rise in U.S. manufacturing unit labor costs since 1985, against dollar-terms increases of 50%-80% in Japan and Germany.

Despite another difficult year for world trade in 1992, which will hit the capital goods demand so vital to U.S. exporters, the labor cost edge should underwrite some further market share gain for U.S. firms. Moreover, though the European market will be slow to revive and sales to will OPEC fall off after the first needs of Kuwait reconstruction are met, U.S. exporters can expect recoveries during the second half of 1992 in Canada and Japan plus continuing strong demand in Latin America and the rest of Asia.

Venezuela's failed coup: a social reminder-note for Latin America?

February 4's failed military coup changes Venezuela's perceived country risk and should remind others in the region of the risks of ignoring the social costs of stabilization and structural reform.

Although corruption and crime have contributed to violent street demonstrations, from an economic perspective the failed coup probably owed much to the steep fall in real wages since the mid-1980s. This has hit a mid-level military further disaffected by procurement scandals and nationalistic discontent over relations with Colombia. The fall in real wages was triggered by the 1986 oil-price collapse and real devaluation of the bolivar, then exacerbated by the 1989 recession and the initial surge in inflation bred by price and market liberalization. The average worker has yet to see tangible gain from the economy's burst of prosperity in 1990-91 (real GDP growth last year topped 9%), no matter the foreign euphoria and huge investment inflows engendered by privatizations, financial reform, and import opening. These radical steps, after all, are at the least disorienting for many in the long-cosseted Venezuelan economy.

The government seeks to patch things up by a new emphasis on "social content," including a 3-year "social mega project" to boost spending on social services and a rise in the minimum wage (in nominal terms). Both will be expensive at a time when revenues, of which three-quarters come from the oil sector, are being squeezed by falling oil production and prices. Broadly measured, the fiscal deficit is rising. This will keep inflation from dipping below its recent 31% annual pace — and could send it higher if a major increase in *real* wages is attempted to purchase social harmony.

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Europe

Germany. With real GDP up 1% year-on-year in the final quarter of 1991, some do not yet speak "recession" of Germany. Yet this is hard to deny after three consecutive quarterly declines in seasonally adjusted activity — and now the probability of no significant recovery during 1992.

- December industrial production was down 0.8% from one year earlier and manufacturing orders were off 3.8%. Even after a possible slight rebound in January, the industrial sector still will languish in deepening difficulty for profits and productivity.
- Driven by past profits and higher taxes, union pressure stays intense for major real wage hikes from this year's bargaining (plus nominal catch-up for 4% inflation) and seems oblivious to future job losses.
- The Bundesbank will not relax its countervailing high interest rates until the labor cost tide has turned — that is, not this side of July. Its reward: inflation well below 3% by year-end, with steep falls by then in both nominal and real interest rates. Its sacrifice: prolonged stagnation in West Germany and drag on East Germany's revival.

Elsewhere in Western Europe, a similar balance of reward and sacrifice will prevail, and in economies mostly more depressed than Germany's.

- As unemployment soars afresh, the U.K. economy now can show no worthwhile pick up before the probable April election.
- Low inflation is becoming entrenched; exceptions: Italy and Spain.

Eastern Europe and Russia. Western Europe's stagnation will help assure Eastern Europe a fourth consecutive year of recession in 1992 amid the continuing struggles of transition to market economies.

- The few positive macroeconomic signs include good performance and prospects for Hungary's exports to the EC and a probable end to inflation escalation in both Hungary and Poland.
- Russia's stabilization and reform efforts are failing amid political division, hyperinflation, and an economy offering no evident floor.

Europe: real GDP forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991	1992				Q4/Q4 change	
	1991f	1992f	Q4	Q1f	Q2f	Q3f	Q4f	1991f	1992f
Major 4	1.0*	0.9*	-0.3	1.6	0.6	1.6	2.0	0.7	1.5
% change over year ago			0.7	0.4	0.6	0.9	1.5		
West Germany	3.1	0.0	-0.8	4.0	-1.6	-0.8	0.4	1.1	0.5
% change over year ago			1.1	-0.3	-0.1	0.1	0.5		
France	1.2	1.4	0.0	0.8	0.8	2.4	1.2	1.6	1.4
% change over year ago			1.6	1.7	1.3	1.3	1.4		
Italy	1.1	1.3	0.8	0.8	1.6	2.8	4.0	1.3	2.4
% change over year ago			1.3	0.9	0.9	1.5	2.4		
United Kingdom	-2.4	0.7	-1.2	0.0	2.4	3.2	3.2	-1.7	2.1
% change over year ago			-1.7	-0.8	0.4	1.0	2.1		

* All Western Europe, except Greece, Ireland, and Portugal.

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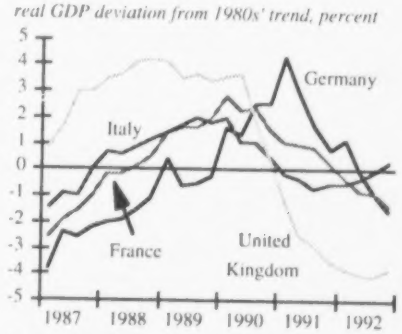
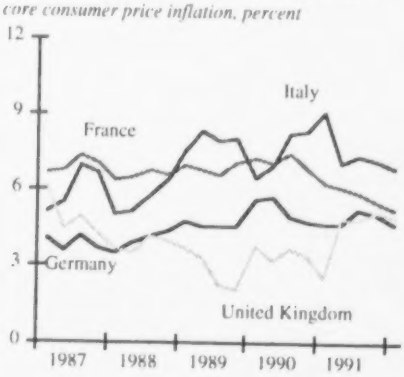
Output gaps

real GDP deviation from 1980s' trend, percent

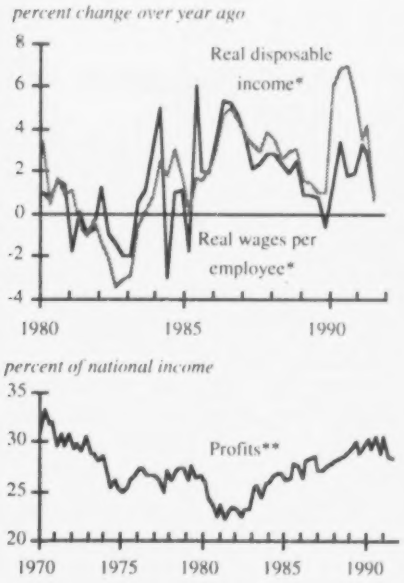


Real government bond yields

10-year nominal yields adjusted for year-ahead core consumer price inflation, percent

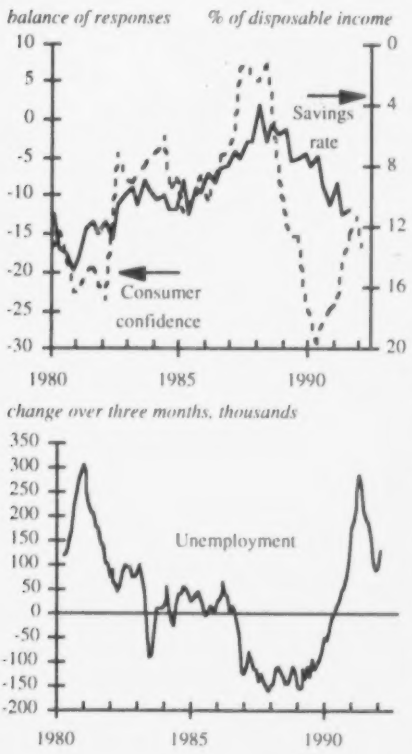


Germany: incomes conflict



*Inflation adjusted by personal consumption expenditure deflator.
**Gross entrepreneurial and property income.

U.K. confidence, saving, and unemployment



Germany: dividing the pie

Until the late 1980s, the Bundesbank's monetarism worked well to restrain inflation and conform business, labor, and government behavior. But 1990 brought the unexpectedly abrupt unification of the nation. Monetary rules from the old days cannot apply cleanly in the new.

Analysts dispute whether the DM's use as a parallel currency in Eastern Europe or approaching changes in interest income taxes warrant the 5.7% growth of M3 in December 1991 over the fourth quarter of 1990 — above the 5% upper target limit — let alone the M3 over-run that seems fairly sure to prevail through much of 1992 relative to the 3.5%-5.5% target announced for this year. For the Bundesbank, however, the proximate penalty from fast monetary growth lies with its market credibility and its next-door presence by the management-labor wage-bargaining table for 1992.

This month's 6.3% steelworker pay settlement sets an unpromising opener to this year's cycle. Labor is aggrieved by the shift in income distribution toward profits during the 1980s (needed as this was for investment), more recently by last July's tax hike, and prospectively by the plan to raise value-added tax next January — actions tolling disposable incomes for a contribution to East German conversion. Conversion is no free lunch; its price is inflation, higher taxes (or reduced spending in the West), or high real interest rates and mounting unemployment (now openly above 17% in East Germany). The Bundesbank is bent on halving present inflation to its 2% medium-term target. The government is timid on the fiscal issues. That leaves sustained high interest rates, at least through mid-year, until cumulative job losses bring expectations down to earth and the economy redevelops some possibility for growth.

United Kingdom: a confidence conundrum

Failure of the U.K. economy to recover in line with the confident assertions offered through much of 1991 can be pinned in part on the lack of recovery in the world at large, in Europe more particularly. This has dashed rosy visions of an export-led U.K. re-expansion and must have contributed to the erosion of U.K. business confidence late last year.

Such visions were perhaps misplaced in light of the sizable U.K. current account deficit (1.4% of GDP in 1991) recorded in the trough of domestic recession — a conjunction seen by some as *prima facie* evidence of sterling overvaluation, even if by nowhere near the margin that exacerbated recession in the early Thatcher years. U.K. recovery in 1982-83 was propelled by interest rate cuts and an attendant slide in sterling. With sterling now in the straitjacket of the ERM, neither relief for the U.K. economy is available today, except insofar as German monetary policy and U.K. inflation expectations permit —which currently leave U.K. real interest rates higher than in the 1987-90 boom years.

U.K. accession to the ERM in September 1990 voted for a system that squeezes excess inflation relentlessly. The cost to the real economy can be large and dragged-out, as France discovered in the 1980s with a legacy of near-10% unemployment today. So too now in the United Kingdom, where producer price inflation is quickly nearing the low European average and unemployment is reaching toward the lofty French level.

The pitfall of fast-falling inflation for U.K. recovery resides in consumer confidence and saving. Rising unemployment undermines confidence anew and, for precautionary reasons, puts in doubt the assumed early fall in the savings rate on which depend all forecasts of material domestic demand recovery this year. Moreover, though U.K. goods and services price inflation remains positive, outright deflation has taken hold in house prices — on a wholly unfamiliar scale that plays havoc with confidence and that may not readily yield to lower interest rates, even were these feasible within the ERM's confines.

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Asia/Pacific

Japan. Downbeat production and inventory indicators, Tokyo stock market depression, and political scandals inimical to confidence add up to Japanese "growth recession" through first-half 1992.

- Down 1.9% year-on-year in December, factory output will go lower in coming months as exports stay weak and high inventories are clipped.
- Waning business confidence — lagging, as usual, 1991's second-half monetary easing — points to temporary investment weakness.
- The LDP's political weakness diminishes the scope for strong fiscal stimulus in the immediate future.

Growth will nonetheless return close to 4% late in 1992, investment will gather new steam, and inflation will drift back up toward 3% into 1993.

- Inventory excesses will work out, consumption pick up (even now, based on income and job fundamentals), and public spending step up.
- Sticky services-sector inflation sets the tone for wage increases throughout the economy, and productivity growth is squeezed.

To stimulate money supply growth and the economy, one further 1/2 point cut in the ODR is probable — but no more.

- The timing likely lies after the Tankan release in March, perhaps earlier for overnight rates if exchange market conditions permit.
- Real rates in Japan are quite low, arguing against subsequent cuts.

Asia/Pacific NICs. Thanks to high investment and fast-rising trade within the region, real GDP growth this year may average just a half-point below 1991's 7.2% — almost shrugging off another poor year for OECD growth.

- High growth brings high inflation in many of these countries. Some will need currency corrections (depending too on yen/dollar developments) and their relative competitiveness in world markets is an issue both within and beyond the region.

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Emerging markets economic outlook, 1st quarter 1992, Feb 19

Japan: services sector inflation

percent over year ago

* Includes advertising, communications, real estate, and communications charges.

Japan: economic forecast

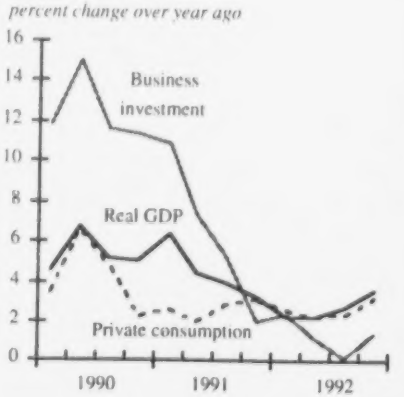
seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991	1992				Q4/Q4 change	
	1991f	1992f	Q4	Q1f	Q2f	Q3f	Q4f	1991f	1992f
Real GDP	4.4	2.7	1.0	2.5	4.2	3.3	4.2	3.2	3.6
% change over year ago			3.2	2.2	2.3	2.7	3.6		
Private consumption	2.7	2.6	0.1	0.3	4.6	4.4	3.5	3.1	3.2
% change over year ago			3.1	2.6	2.2	2.4	3.2		
Business fixed investment	6.2	1.3	-0.4	10.7	-7.3	-7.3	-1.4	2.0	1.4
% change over year ago			2.0	2.4	1.2	0.2	1.4		
Residential investment	-7.8	-0.3	-19.5	36.0	0.0	-1.1	-13.0	-15.0	4.0
% change over year ago			-15.0	-6.5	0.0	2.0	4.0		
Net exports*	1.2	0.4	0.5	-0.4	2.2	0.2	-0.7	0.9	0.4
Change over year ago			0.9	0.2	0.6	0.8	0.4		
Consumer prices (Tokyo, %oya)	3.3	2.5	3.2	2.3	2.8	2.7	2.2	3.2	2.2
Trade balance (customs, $bil.)	78	81	85	101	69	77	81	50	-4
Current account (nsa $bil.)	73	75	86	103	70	66	70	60	-16

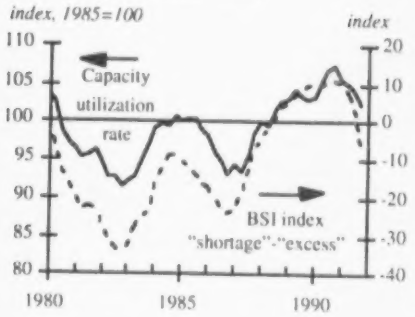
* Percentage-point contributions to real GDP growth.

Japan: real GDP

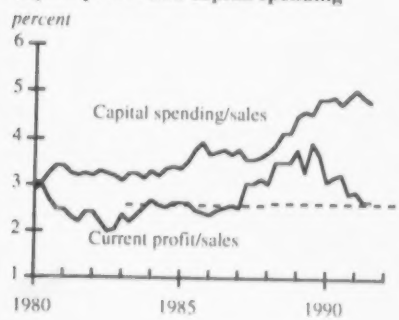
percent change over year ago



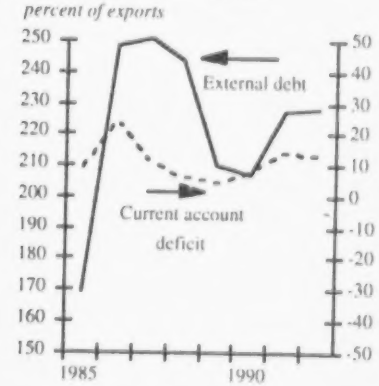
Japan: capacity utilization



Japan: profits and capital spending



Indonesia: external debt and the current account deficit



Japan's business investment: no nose-dive in progress

The low estate of the Tokyo stock market, poor profits in such high-profile industries as consumer electronics, falling industrial production, and the worsened global economic outlook are often cited as harbingers of imminent major cutbacks in overall Japanese business investment.

Some shrinkage in such spending does seem probable during the next half-year, yet the fundamentals remain cautiously positive for recovery after that.

Cheap equity funding may indeed be a thing of the past, but only ever benefited a fraction of Japanese industry. For large firms, internal funding is vastly more important — and now is depressed only relative to the exceptional heights of liquidity attained two years ago. Meanwhile, the cost of external borrowing recently has fallen sharply; long-term prime lending at 6% translates to the lowest real interest rates in a decade. To be sure, the banks' ability and willingness to lend is in question, given pressures on their capital and the losses they face in real estate. But evidence of reluctance to lend outside real estate so far is lacking. And deregulated interest rates and slim returns from "safe" investments — returns that may sink lower — should nudge banks into business lending.

Nor is reduced current profitability a significant impediment to business investment; it has not been so in the past, nor is it severely depressed today by historical norms. Instead, future profitability is key. To the extent that this is conditioned by present perceptions of capacity shortage or excess, the picture through the end of 1991was not discouraging by past standards; and the latest business surveys are still upgrading estimated real capital spending in the current fiscal year (JPM forecasts about 4% growth, followed by 1% in FY1992). In sum, though confidence factors are something of an imponderable, objective considerations point to investment recovery late this year.

Indonesia: diversifying industrially, tightening policy, but still oil-price exposed

Despite its late-1980s' diversification away from petroleum, Indonesia's economy remains overheated and debt-laden — and hence vulnerable should oil prices crumble.

The 1986 oil-price collapse inspired extensive domestic deregulation, reduction of tariff and non-tariff barriers to imports, a 40% real effective depreciation of the rupiah from the 1985 level, and economic opening to domestic and foreign investors. All this made possible 6.2% annual real GDP growth in the 5 years up to 1991 (up from 5.6% earlier in the 1980s when oil prices stood high). It also raised non-oil exports — mostly manufactures — from less than one-third the total in 1985 to nearly two-thirds in 1991, a 9.5% annual volume increase. This rise has been propelled not only by structural reforms at home but also by a modest real wage level that enables Indonesia, like some other Asian NICs, to attract a significant share of the ongoing shift in labor-intensive manufacturing and associated investment out of cost-disadvantaged Asian "Tigers."

Indonesia's investment boom has bred economic overheating that pushed inflation close to 10% in 1991 — scant pay-off for two years of attempted monetary restraint. Under liberalization, this has been negated by heavy external finance inflows bloating both foreign exchange reserves and total foreign debt — the latter by way in excess of current account deficit financing needs. The debt reached $72 billion by end-1991 and rose significantly relative to export earnings. The government now has moved to restrain its spending and the public-sector's borrowing abroad, especially for "mega projects" promising slow or uncertain return. The worry must be that export growth, especially in the oil sector, may falter in a sluggish world economy and so erode the confidence of domestic and foreign investors as to render Indonesia's accumulated high debt less manageable.

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Effective exchange rates

*index numbers, 1980-82 average = 100**

	1989	1990	1991	1990 Q4	1991 Q1	1991 Q2	1991 Q3	1991 Q4	1991 Jan	1991 Sep	1991 Oct	1991 Nov	1991 Dec	1992 Jan
Nominal against 15 industrial-country currencies														
United States	91.3	86.5	85.5	81.7	82.8	87.7	87.6	84.0	82.2	86.1	85.3	83.8	82.8	83.0
Japan	172.8	156.8	170.0	168.5	165.9	167.6	170.4	175.3	165.2	171.2	175.7	175.0	175.1	179.7
Canada	100.5	100.7	102.5	100.0	100.7	102.8	103.3	103.2	100.4	103.5	104.3	103.6	101.7	100.8
Australia	65.6	62.4	61.5	59.0	59.6	62.3	63.2	61.0	59.3	63.2	62.7	61.2	59.0	57.2
Germany	121.0	124.9	124.2	125.8	125.7	122.9	123.4	125.0	125.9	124.0	124.0	125.1	125.9	125.6
France	84.9	88.2	86.8	88.8	87.7	86.2	86.2	86.9	88.0	86.4	86.3	86.8	87.5	87.4
Italy	80.6	81.3	80.3	80.6	80.8	80.2	79.9	80.2	80.7	80.1	80.1	80.1	80.3	80.4
United Kingdom	81.3	79.3	80.0	81.7	81.4	79.8	79.3	79.3	81.6	79.5	79.1	79.3	79.4	79.1
Belgium	94.2	97.7	97.8	98.2	98.4	97.1	97.2	98.2	98.5	97.5	97.6	98.2	98.7	98.5
Denmark	99.0	104.7	103.3	105.3	104.9	102.9	102.4	103.2	105.1	103.0	103.0	103.1	103.5	103.5
Netherlands	113.6	116.4	115.7	116.7	116.7	114.9	115.2	116.3	116.9	115.5	115.6	116.3	116.9	116.7
Spain	78.9	81.8	81.8	82.3	83.1	81.7	81.0	81.3	82.9	81.3	80.9	81.5	81.5	81.8
Sweden	81.2	79.0	78.9	78.0	78.3	79.1	78.5	79.1	78.0	78.6	78.6	79.1	79.7	79.8
Switzerland	115.8	121.3	119.7	123.9	122.7	120.7	117.9	117.7	124.7	117.9	117.8	117.4	118.0	117.3
Real (relative wholesale-price adjusted) against 18 other industrial-country currencies and 22 emerging-market currencies														
United States	96.8	92.5	91.9	88.9	89.9	93.8	93.5	90.5	89.6	92.0	91.9	90.3	89.4	89.4
Japan	121.6	107.6	114.6	114.0	112.5	113.6	115.1	116.8	112.3	115.1	117.5	116.6	116.3	118.7
Canada	107.8	103.4	102.5	100.6	100.6	103.6	103.3	102.2	100.1	103.0	103.6	102.4	100.6	99.4
Australia	98.5	94.7	93.4	90.8	91.3	94.7	95.4	92.0	91.1	95.5	94.6	92.2	89.2	86.1
Germany	104.6	107.9	105.8	108.5	108.1	104.8	104.4	106.0	108.5	105.1	104.8	106.1	107.2	106.4
France	100.2	104.2	102.5	105.0	103.7	101.4	101.6	103.2	104.2	102.0	102.2	103.1	104.4	104.0
Italy	107.8	110.1	107.4	109.7	109.4	107.0	106.3	106.9	109.7	106.6	106.5	106.8	107.3	106.9
United Kingdom	94.1	96.1	99.6	100.7	101.6	99.0	98.4	98.9	101.9	98.9	98.3	99.0	99.5	100.2
Belgium	79.7	84.1	84.3	84.2	84.7	83.9	83.9	84.7	84.5	84.4	84.7	84.5	84.9	85.1
Denmark	106.0	111.4	108.1	112.2	109.9	108.2	106.6	107.9	109.4	108.2	107.9	108.1	107.8	106.0
Netherlands	107.0	109.8	110.0	111.3	110.1	107.6	109.7	112.6	110.6	110.8	111.1	112.5	114.1	113.9
Spain	109.6	116.4	117.4	117.4	119.7	116.7	115.9	117.3	119.0	116.6	116.3	117.7	117.9	118.9
Sweden	105.1	103.6	102.2	102.3	102.4	102.1	101.4	102.6	102.5	101.7	101.3	102.8	103.8	104.2
Switzerland	106.4	114.8	116.0	118.8	118.6	116.0	114.0	115.1	120.1	114.6	114.6	115.2	115.7	115.5
Argentina	50.0	58.8	69.1	76.0	68.5	69.7	69.1	67.7	69.3	68.1	68.7	67.5	66.9	67.0
Brazil	98.3	117.8	90.5	97.7	91.6	90.2	94.8	85.3	91.4	94.2	87.8	86.5	81.5	79.2
Chile	62.3	60.0	65.0	61.4	61.7	66.0	66.6	65.1	61.6	65.9	66.2	65.3	63.8	65.6
Mexico	74.0	69.2	75.3	68.6	71.6	75.3	76.1	76.9	70.5	75.8	75.9	77.2	77.7	78.6
Venezuela	62.0	52.4	51.7	50.3	50.0	52.4	51.9	52.7	50.4	52.0	52.8	53.3	52.0	52.4
Hong Kong	98.6	98.9	106.1	98.4	98.1	108.4	108.7	109.4	96.9	108.3	110.2	110.6	107.4	106.4
Indonesia	55.3	54.4	54.4	51.8	52.5	55.0	55.9	54.1	51.7	55.1	54.6	54.3	53.4	53.1
Korea	92.2	84.9	83.3	81.8	82.5	85.6	84.9	80.3	82.2	83.2	81.6	80.0	79.1	78.6
Malaysia	79.4	75.8	75.6	72.6	73.9	76.6	76.5	75.3	73.3	75.9	76.3	75.4	74.1	76.5
Philippines	95.4	88.5	87.2	82.2	81.2	85.0	90.2	92.7	82.7	91.1	89.9	94.5	93.9	95.4
Singapore	78.1	80.5	83.0	80.6	80.6	82.6	84.2	84.5	80.2	83.9	84.1	84.2	85.1	85.8
Taiwan	100.8	93.8	92.7	91.4	91.1	93.1	93.9	92.6	91.3	93.3	92.6	92.7	92.7	94.3
Thailand	77.1	74.6	79.5	76.1	76.5	79.2	79.8	82.3	76.5	79.5	83.3	82.2	81.3	81.9

* A currency's nominal effective exchange rate is an index of its trade-weighted average value against the currencies of the country's principal trade partners. The real effective exchange rate, which adjusts the nominal index for relative price changes, gauges the effect on the international price competitiveness of the country's manufactures due to currency changes and differential inflation. The relative price changes are based on indices most closely measuring the prices of domestically produced finished manufactured goods, excluding food and energy at the first stage of manufacturing. The weights for the currency indices are derived from 1980 bilateral trade patterns of the corresponding countries.

J.P. Morgan Government Bond Index: total return performance

percent change, end of period from like preceding period

	1989	1990	1991	1990 Q2	1990 Q3	1990 Q4	1991 Q1	1991 Q2	1991 Q3	1991 Q4	1991 Nov	1991 Dec	1992 Jan
In local currency terms													
United States	14.0	8.6	14.8	3.3	1.0	5.2	1.9	1.4	5.5	5.3	1.1	3.2	-1.4
Japan	-1.5	0.8	13.8	2.7	-4.4	8.8	2.1	0.5	6.1	4.4	0.7	2.8	0.7
Canada	12.8	7.4	21.0	4.8	1.3	6.7	5.9	0.3	7.3	6.2	0.9	2.3	-0.5
Australia	13.7	18.8	26.3	3.5	4.4	8.3	5.3	3.7	6.5	8.6	0.9	3.3	-2.9
Germany	1.0	1.1	11.9	1.3	0.4	2.7	4.1	1.9	2.3	3.1	0.9	1.5	2.0
France	4.1	7.3	15.9	2.4	-1.2	4.7	6.4	2.1	3.4	3.2	-0.2	2.2	1.3
Italy	12.0	14.6	17.2	5.2	2.3	3.1	4.9	3.9	4.0	3.4	0.0	1.5	1.8
United Kingdom	8.0	9.5	16.8	7.2	1.0	7.5	6.7	0.8	7.2	1.3	-0.2	1.2	2.6
Belgium	2.0	8.8	13.3	3.0	-0.3	4.0	4.9	2.1	2.9	2.7	0.5	1.4	2.1
Denmark	5.0	10.2	16.1	4.1	-0.2	4.0	6.2	2.7	2.9	3.5	0.3	1.9	1.7
Netherlands	-0.2	3.3	11.4	1.8	0.4	2.8	3.9	2.1	1.9	3.1	0.5	1.8	2.1
Spain	9.2	14.8	17.5	4.0	2.2	4.6	6.5	4.3	3.8	1.9	0.1	1.2	1.9
ECU	..	7.4	16.2	3.9	0.6	5.1	5.9	2.5	3.8	3.2	0.2	2.6	1.5
In dollars													
United States	14.0	8.6	14.8	3.3	1.0	5.2	1.9	1.4	5.5	5.3	1.1	3.2	-1.4
Japan	-14.5	7.2	23.4	6.5	5.3	11.3	-1.7	2.7	9.9	11.2	1.5	7.0	0.1
Canada	16.1	7.2	21.5	5.3	2.0	6.4	6.0	1.8	8.2	4.0	-0.2	0.4	-2.1
Australia	5.1	16.2	24.3	8.7	8.9	1.2	5.6	2.6	11.0	3.3	1.6	0.1	-4.1
Germany	5.6	14.8	9.8	3.1	6.5	8.1	-8.7	-4.2	11.2	13.0	3.8	8.7	-3.8
France	8.9	22.4	13.4	4.4	5.1	8.4	-6.1	-4.2	11.8	12.7	2.9	9.3	-4.2
Italy	15.5	28.8	15.1	7.3	6.4	7.3	-6.2	-2.4	12.4	11.9	2.4	8.0	-3.1
United Kingdom	-3.7	31.3	12.8	13.7	8.2	11.1	-3.6	-6.4	15.7	8.1	1.4	7.1	-1.8
Belgium	6.7	25.2	12.0	5.9	5.5	8.7	-7.3	-4.0	11.8	12.5	3.5	8.4	-3.6
Denmark	9.1	25.6	13.5	6.1	5.6	7.6	-6.4	-3.5	11.9	12.4	3.0	8.8	-4.0
Netherlands	4.5	17.2	9.5	3.6	6.3	8.2	-8.7	-4.1	10.8	12.9	3.5	9.0	-3.6
Spain	13.1	31.1	16.6	10.5	6.6	7.1	-3.4	-2.7	11.6	11.2	1.6	8.2	-3.0
ECU	..	24.3	12.9	6.7	6.6	9.9	-6.6	-4.0	12.3	12.1	2.7	9.3	-3.5
Global	6.8	11.8	15.5	4.7	3.1	7.0	-0.8	-0.1	8.0	7.8	1.6	5.1	-2.0
Global excluding United States	-2.4	15.6	16.0	6.5	5.7	9.1	-4.3	-2.0	11.4	10.9	2.3	7.4	-2.6

J.P. Morgan Government Bond Index: 10-year constant-maturity yields

*percent per annum, semiannual basis**

	1989	1990	1991	1990 Q2	1990 Q3	1990 Q4	1991 Q1	1991 Q2	1991 Q3	1991 Q4	1991 Nov	1991 Dec	1992 Jan
United States	7.91	8.06	6.69	8.41	8.80	8.06	8.03	8.23	7.45	6.69	7.41	6.69	7.28
Japan	5.59	6.65	5.57	6.70	7.93	6.65	6.58	6.78	6.07	5.57	5.99	5.57	5.57
Canada	9.56	10.28	8.25	10.69	11.19	10.28	9.52	10.06	9.09	8.25	8.64	8.25	8.52
Australia	12.93	12.05	9.39	13.38	13.62	12.05	11.38	11.16	10.32	9.39	9.78	9.39	10.10
Germany	7.26	8.99	8.05	8.69	9.11	8.99	8.51	8.49	8.38	8.05	8.30	8.05	7.90
France	9.37	9.97	8.57	9.63	10.53	9.97	9.10	9.16	8.87	8.57	8.88	8.57	8.44
Italy	14.08	14.54	12.88	13.20	14.61	14.54	13.68	13.32	12.90	12.88	13.00	12.88	12.60
United Kingdom	10.20	10.96	9.75	11.76	12.19	10.96	10.12	10.49	9.58	9.75	9.87	9.75	9.40
Belgium	9.42	9.97	8.88	9.68	10.53	9.97	9.36	9.35	9.10	8.88	9.13	8.88	8.60
Denmark	10.25	10.49	8.73	10.20	11.01	10.49	9.38	9.28	9.06	8.73	9.04	8.73	8.51
Netherlands	7.84	9.15	8.56	8.84	9.29	9.15	8.73	8.75	8.77	8.56	8.80	8.56	8.36
Spain	14.12	14.60	11.27	14.43	15.11	14.60	12.52	11.94	11.30	11.27	11.68	11.27	10.82

* For each of the J.P. Morgan Government Bond Index countries, the data are calculated as the semiannual yield of the single most liquid bond component within four months of the stated maturity.

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World Financial Markets

May/June 1992

Japan's economy: shifting gears for the future

Equity and real estate market declines threaten, but do not necessarily presage, an unmanageable "credit crunch" that will cripple the economy.

- If the authorities maintain easy money and public confidence amid current financial stress, and enact soon a sizable FY1992 supplementary budget, plentiful jobs and strong consumer fundamentals can prevent a serious economic downturn this year or next.

Longer-term prosperity requires a new reorientation of Japan's economy.

- Business investment, though it will hold up well this year in absolute terms, is not sustainable at 20% of GDP.
- Nor, without increasing international friction, could a weak yen and rising current account surplus provide the offset to sustain growth.
- The solution: more emphasis on fiscal taxation and spending policies that will speed growth in Japanese consumers' living standards.

Japan's banks: grappling with past and present

The banks' asset quality, accounting transparency, and capital adequacy problems haunt financial markets and could threaten confidence at large.

- Regulators will not force sweeping loss recognition, rapid BIS capital ratio compliance, nor asset "fire sales" at home and abroad.
- Sooner or later, perhaps with government financial assistance, bank consolidations will prove necessary to strengthen core earnings.

A cost of capital disadvantage for Japan?

The accompanying J.P. Morgan study of equity and debt funding costs finds that real capital costs facing Japanese nonfinancial firms now are their highest in years — and even above those of U.S. rivals.

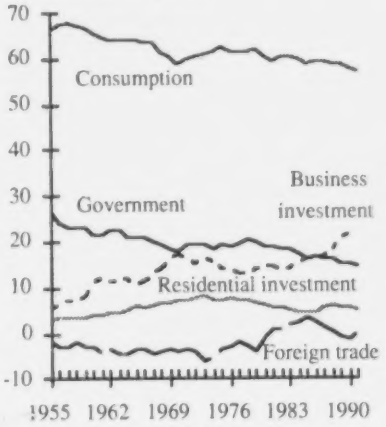
Global economic outlook

Signs of U.S. recovery are not matched in other G-7 economies.

- Sluggish G-7 monetary growth provides minimal spur to economic growth worldwide and points to continuing low global inflation.
- Japanese and U.S. short-term interest rates are at or near their lows, but U.S. bond yields have potential to fall; European markets at all maturities may have to wait six months more for Bundesbank relief.

Structural imbalances in the Japanese economy

percent shares of GDP



Contents

Japan's economy: shifting gears for the future, 3
Asset inflation and the economy, 4
Bubble-burst fallout in the real economy, 5
Households' response, 6
Business investment response, 8
The inventory cycle and near-term economic growth, 11
Monetary and fiscal policy for economic recovery, 11
A perennial issue: Japan's underconsuming growth bias, 12

Japan's banks: grappling with past and present, 15

Global economic outlook in summary, 18

Global economic outlook, 19
The Americas, 20
Europe, 22
Asia/Pacific, 24

Effective exchange rates, 26
J.P. Morgan Government Bond Index, 27

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Economic Research

Japan's and the Fed's next move
Patricia Hagan Kuwayama, 1 page, April 10
Japan's ample liquidity, the yen's weakness, and already-low interest rates increase the advantages of fiscal policy to spur the economy.

Economic briefing
Patricia Hagan Kuwayama, 12 pages, March 27
Medium-term 1992-1993 outlook for Japan's macroeconomy, with concise supporting detail.

JPM Advisory/Counterparty Risk Mangement-Tokyo

Can Japan's banks meet the BIS rules? (accompanying)
Richard P. Mattione and Keiko Mizuguchi, 5 pages, April 17
Impacts of stock market decline and yen weakness on capital positions of 31 major Japanese banks, individually and in total.

A capital cost disadvantage for Japan?
Richard P. Mattione, 30 pages, April 1992
The equity funding disadvantage and adverse prospective profit impact faced by Japanese firms from the recent stock market decline and late-1980s' overinvestment.

Derivatives Research

Nikkei 225 volatility: cause and effect
Bart Broadman, 2 pages, April 10
Aspects of the stock market decline that are heightening investor awareness and the practical merits of equity and other derivatives strategies.

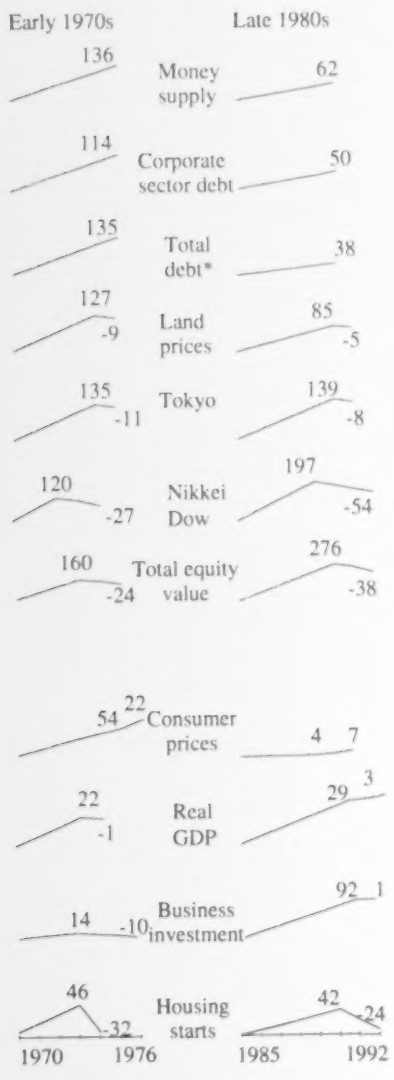
Markets Research

"Market vulnerability to Japanese pullback"
Jan Loeys, 1 page, *Global Markets*, April 1992
Vulnerability not major for global stock markets; significant for bonds denominated in Belgian francs, sterling, and the Australian, Canadian, and U.S. dollars.

Japanese investments in U.S. securities
Jan Loeys, 1 page, April 9
Magnitude and outlook for Japanese outstandings and net capital flows vis-à-vis U.S. equity and bond markets (update of the comprehensive *Japanese investment in U.S. securities*, Jan Loeys, 16 pages, April 19, 1991).

Japan's economy: shifting gears for the future

Japan: bubbles then and now
percent change



*Total nonfinancial debt including household and government.

The economy is losing altitude; business sentiment is in free-fall; equities have lost more than half their value since 1989; financial institutions face huge losses; and government is bogged down in political scandals and confusion. So goes the pessimists' litany of Japan today, almost as celebration of the bursting of the "bubble" economy of the late 1980s. The litany is broadly true, but misleads.

Shake-outs in stock and real estate markets and falling manufacturing output are aspects of a post-bubble adjustment process already two years under way (see diagram). Adjustment will continue at least two more years, but its maximum effect on economic growth probably is occurring now.

The government's 3.5% GDP growth forecast for fiscal 1992 almost certainly is too optimistic, and there is a clear danger that the current economic slowdown could compound into outright decline if business and investor confidence is allowed to fail. Indeed, in order to avoid this outcome, there is a need to manage the stress on Japan's banks in a way that minimizes risks to the economy (the challenges facing the banks are addressed in the article on page 15).

There is an equal need to continue easy monetary policy and increase fiscal stimulus to buttress the economy's underlying strengths. In today's Japan, strong labor markets underpin consumer confidence and demand; there are no signs of an overall "credit crunch" that would strangle economic activity; monetary easing has cut short- and long-term borrowing costs for households and businesses; and additional economic stimulus should, and most likely will, tilt to fiscal policy via public lending and investment. These positives will buoy business investment for the next year or so (though the manufacturing component must take a hit) and enable post-bubble correction without a serious economic downturn.

Further into the 1990s, however, it is optimistic to suppose that Japan can sustain somewhere near 4% overall GDP growth — the objective sought by the government — without a new rebalancing of the engine of growth.

Rebalancing is not a new challenge: the Mayekawa report six years ago called on Japan to reorient growth away from exports; through 1990, yen appreciation and soaring business investment worked well to this end, until the drop in the stock market and a squeeze on profitability revealed the extent to which investment nudging 20% of GDP had swollen out of line with ultimate demands at home and abroad.

The time now is ripe for a shifting of gears: to make rising household incomes and consumption the new engine of growth. Logically, taxation and public spending policies can be relaxed and redeployed to this end — a challenge that governments around the world can only envy for Japan.

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Asset inflation and the economy

Asset inflation in the second half of the 1980s had its origin in the explosive growth of the money stock (see Chart 1) that resulted from aggressive interest rate easing after the September 1985 Plaza Agreement. To demonstrate commitment to G-7 coordination but avoid a "yen-shock" recession, the Japanese authorities relied until the spring of 1987 almost exclusively on monetary stimulus, cutting the official discount rate by half to 2.5%. By the time they loosened their tight fiscal stance, in May 1987, enormous excess liquidity had already been created. This fueled a speculative boom to which the government's expansion of public works became one more spur. The result was escalating prices of land and equities, the domestic assets most favored by investors riding the speculative wave.

Asset booms are a familiar feature of Japanese expansions. The 1986-89 boom can be compared with the experience of the early 1970s, when Prime Minister Tanaka's grandiose plan for "Restructuring the Japanese Archipelago" ushered in a period of soaring asset values (see the diagram on page 3). Monetary growth and nationwide land-price inflation were milder in the second half of the 1980s than in the earlier boom but, as yet, remain above their long-term trend in relation to GDP (using the period between the two booms as a standard). Equity prices, by contrast, rose faster in the recent boom before correcting more substantially (see Charts 2 and 3).

Another important contrast: consumer price inflation soared in the 1970s, peaking at 23% and keeping interest rates high long into the post-bubble adjustment phase; in the late 1980s, the yen's doubling in value in terms of the dollar meant that goods and services prices hardly rose, which has given the Bank of Japan leeway to cut interest rates sharply to bolster the economy.

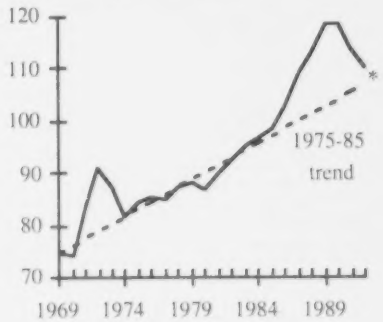
The unique feature of the 1980s' land-price boom was its concentration in the main metropolitan areas. An explosion of newly deregulated and internationalizing financial industries concentrated business expansion in Tokyo and other major cities. After rising 145% over five years, posted prices in the main metropolitan areas (Tokyo, Osaka, and Nagoya) fell 12% in the year to January 1, 1992. The true decline, particularly in areas such as central Tokyo where transactions are infrequent, likely was greater, such that published indices — and the condition statements of affected enterprises — may continue to drop long after the economic impact has been felt.

Equity price appreciation in the late 1980s was cumulatively larger but more gradual than in the early 1970s. The entire boom and bust took three years in the earlier episode; it already has lasted more than twice as long in the current one. Despite the severity of the decline in equity values since 1990, the traditionally high debt/equity ratios of Japanese companies have receded more into line with those of U.S. firms because their late-1980s' borrowing was

Chart 1

Money supply

M2+CDs outstandings, year-end, as percent of nominal GDP



* Latest plot Mar 1992.

Chart 2

Land prices

1970=100, beginning of year

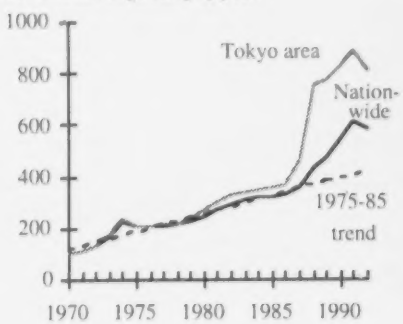
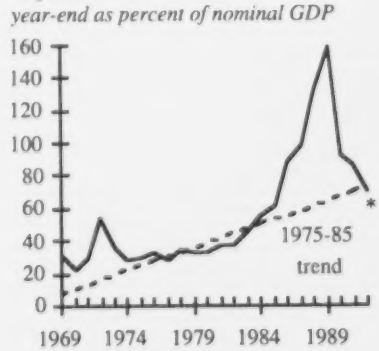


Chart 3

Equities: market value

year-end as percent of nominal GDP



* Latest plot Mar 1992.

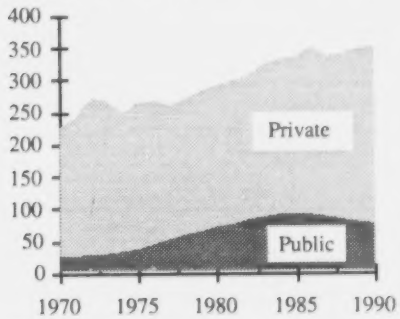
Chart 4

Corporate-sector debt
gross, percent of GDP

Source: Ministry of Finance, *Corporate finance survey.*

Chart 5

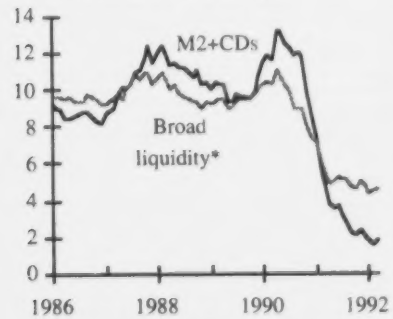
Nonfinancial sector debt
gross, percent of GDP



Source: Bank of Japan, *Flow of Funds.*

Chart 6

Money supply
percent change on year earlier



* Includes some popular substitutes for commercial bank deposits that are not counted in M2+CDs, such as bank debentures and deposits at post offices and credit cooperatives.

quite subdued. Most of this borrowing was by nonmanufacturing firms (see Chart 4).* Manufacturers opted more for equity finance. Nor, among other nonfinancial sectors, did households' borrowing surge. Most striking, debt of central and local authorities, as well as public enterprises, rose only 14% in the five years to 1990, slashing their overall debt/GDP ratio by 15 percentage points, to 76% from over 90%. Total nonfinancial debt in Japan grew only slightly faster than GDP during the second half of the 1980s (see Chart 5) — in sharp contrast with the United States, where debt ratios rose for all domestic sectors.

While the good times rolled in Japan, however, the underdeveloped state of many of its asset markets led to new pricing distortions and unusual financial practices. Large corporations were able to raise funds at exceptionally low cost: the newly created commercial paper market offered companies financing at below the return on bank CDs during most of 1988; and, as equity prices rocketed higher, warrants or other equity conversion features enabled bond issuance at near-zero or even negative effective cost to some borrowers. Many of these cheap funds were placed in financial assets. Corporate liquidity on standard measures jumped to unheard-of levels (see Chart 13 on page 9). Some manufacturers even reported earnings from bond investment and other financial activities (*zaitech*) that were larger those than from their main businesses.

* Nonmanufacturing includes construction and real estate, the sectors most engaged in property-related investments. Measured nonmanufacturing borrowing rose a few percentage points of GDP as NTT and Japan Rail were reclassified in 1985-87.

Zaitech has left many firms a cushion for business activities in the post-bubble environment. But *zaitech* funds also found their way into investments directly or indirectly linked to real estate speculation. Banks and other financial intermediaries eagerly provided finance that was — formally or informally — backed by collateral geared to booming land and equity prices. "Bubble illusion," aggravated by murky accounting standards, inflated lenders' estimates of their own profitability and capital, as well as of the soundness of their borrowers.

Bubble-burst fallout in the real economy

Bursting of the bubble — always inevitable but precipitated by the Bank of Japan's forceful monetary tightening in 1989 — has been under way more than two years already. The fall in equity and land prices has spread disillusion across the financial sector and has taken toll of spending in areas previously favored by speculation or new wealth. But it has not devastated Japan's overall economic performance or outlook.

Of course, a tighter credit environment has not gone unfelt in the economy at large over the past two years. Bank lending growth dropped from over 10% annually in 1987-89 to less than 4% in late 1991, with corresponding crumbling of bank liability and money supply growth (see Chart 6). Broad

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liquidity growth, however, has slowed much less because other credit intermediaries partly substituted for down-sizing banks. Accordingly, apart from real estate lending, there has been no credit "crunch" in the sense of reduced availability of financing for traditional business purposes.

The most important aspects of adjustment relate to imbalances in the real economy itself. Three areas stand out where the bubble boosted spending: housing, luxury consumption, and business investment. Adjustment of the first two seems largely complete. In any case, the chart on page 1 points up that the share of housing activity in overall GDP did not balloon in any unprecedented way during the boom, while the share of private consumption actually continued its long-term decline. Government spending sank markedly as a share of GDP. Business investment, however, more than made up as it soared to an unprecedented 20% share; its sustainability now poses a key uncertainty for the economy in 1992 and beyond.

Households' response

Housing starts surged in the late 1980s. Following initial impetus from strong income growth and low interest rates, home buying received an additional boost from the land-price boom as developers and individual owners rushed to beat escalating prices in one metropolitan area after another. At first, the boom affected all types of housing. Toward the end, speculation focused on small urban condominiums — the segment of the market that now has experienced the biggest decline since mid-1990.

Yet the overall housing stock is not overbuilt. The portion built decades ago is well below today's standards of comfort and safety. Residential rents have risen uninterruptedly throughout the past several years. They have now caught up with materials and construction costs, which had been swollen by the boom but which have eased during the economic slowdown. At the same time, the affordability of home financing has benefited by the drop in home loan rates from a late-1990 peak of 8.5% to 6% currently.

Improving profitability has begun to boost housing starts. By late 1992 they may be up 5% from their end-1991 trough (see Chart 7) and an emphasis on larger and higher-quality units implies that real investment will grow more than the number of units. Thus housing, which subtracted about 0.5 percentage point from economic growth in 1991, should turn neutral by mid-1992 and will contribute significantly to GDP growth later this year and into 1993.

Consumer spending lagged overall GDP growth during the boom, though it did rise unusually rapidly: more than 4% in each of the four years between 1987 and 1990. Consumption of home furnishings and durables was stimulated by the housing boom, faltered in its aftermath last year, but now will pick up again this year as housing expands anew. Auto sales are stabilizing at about 4 million units annually and their real value will gain both this year and next from the shift toward larger and higher-

Chart 7

Housing starts

million units, saar

percent change on year earlier

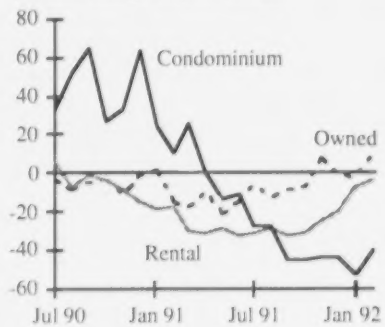

Chart 8

Labor market situation

ratio *percent*

Chart 9

Personal sector

percent of GDP

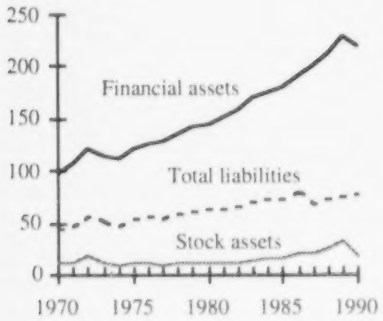

Table 1

Household savings*

millions of yen per household, 1991 Dec

	All households	Workers' households
Net financial assets	10.9	8.2
Gross financial savings	14.7	11.3
Deposits	7.6	5.7
Bank	3.9	2.9
Postal savings	2.1	1.7
Other (including agricultural savings)	1.6	1.2
Insurance	3.6	3.1
Bonds and related trusts	0.5	0.4
Shares and related trusts	1.8	1.0
Loan trusts	0.7	0.5
Outside financial institutions	0.4	0.5
Gross liabilities	3.8	3.1
Home-finance related	3.2	2.8
Net financial assets as of annual income	151.6	111.9
% of households with Any liabilities	47.4	51.9
Home finance liabilities	30.1	33.2
% owning homes	72.4	63.6

* Excludes single-person and agricultural households.

quality models. Moreover, deflation of the erstwhile wealth-induced boom in luxury goods consumption — symbolized by crowds of Japanese tourists thronging designer-goods stores abroad,* but never amounting to more than a small part of total consumption — has largely run its course. It should not obscure the fundamentally strong position of Japan's consumers and their disposition to spend.

Employment conditions are one key strength. Japan's labor markets, even in the current slowdown, display a tightness traditionally seen only in booms. A gradual fall in the job-offers ratio indicates marginal easing (see Chart 8), but its level is still far above the past norm, the unemployment rate has stayed historically low at about 2%, and employment has been growing steadily — manufacturing jobs rose 4% in the past twelve months, or even more than total employment despite the immediate contrary pressures of inventory adjustment.

Working against layoffs, and reinforcing "automatic stabilizers" in the private sector, is the structural scarcity of labor. The labor force, having absorbed the immediate offspring of postwar baby-boomers and now with little scope for further increase in temporary and part-time workers, will grow quite slowly in the years ahead. Anticipating shortages, producers are loath to lose workers — even though this adds to the squeeze on current profits and may also crimp investment. Moreover, the widely publicized difficulty of recruiting full-time employees is heightening workers' confidence in their future employment and income.

Household financial positions, too, are strong — and indeed have gotten stronger in the past six or seven years (see Chart 9). Consumer credit has grown rapidly, narrowing the gap versus U.S. habits. Even so, such credit is tiny in Japanese households' overall balance sheets. And though total liabilities of the personal sector (which includes unincorporated businesses) have increased in line with GDP since 1985, its financial assets have risen substantially faster. By end-1991, 84% of households had more financial assets than total liabilities. Table 1 shows the average family holding ¥11 million in *net* financial assets and 72% owning their homes. About three-quarters of their financial savings are in the form of deposits and insurance. Only about 12% are in equities or equity-related trusts, indicating that households are relatively insulated from market disturbances.

The outlook for Japanese consumption growth is constrained in the near term by the weak earnings position of many employers. On the basis of this, labor representatives have accepted modest spring wage settlements estimated to average 4.9% for 1992 — 0.75 percentage point below last year's — despite the extremely tight labor markets. Assuming little change in employment and the savings rate, real income and consumption will grow only about 2.6% this year, the

* Not only were imports inflated (including art, jewelry, and cars) but also sales at big-city department stores. As this particular bubble deflated, luxury sales fell sharply after mid-1991 but have leveled out in recent statistics.

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same as in 1991. In 1993 consumption growth could pick up to slightly above 3%.

Consumption will not return to its fast growth of the late-1980s unless the broad income and savings trends of the past decade change markedly (see Chart 10). The overall personal savings rate has leveled off over the past several years, after declining steadily from 22% to 14% of disposable income between the mid-1970s and 1988. Thanks to their strong balance sheets, Japan's consumers have room to cut their savings rates further toward the rates common in other industrial countries. Yet they may nonetheless be unable to boost spending growth if they continue to suffer a declining ratio of disposable to total income. This ratio has fallen six percentage points since the mid-1970s, mainly due to rising direct and social security taxes despite the income tax rate cuts that accompanied the 1989 shift to a value-added tax.*

Consumption growth in the 2.5%-3% range is not a problem in itself. But the government's ambition to achieve domestic-led GDP growth of 3.5%-4% annually over the next five years will prove difficult to achieve in the absence of a decline in savings rates or a rise in disposable income shares.

Business investment response

The biggest adjustment to the bursting of Japan's late-1980s' asset bubble has hardly begun. Business capital spending rose almost 15% annually during 1988-90 and alone contributed one-half of the 5.4% average real GDP growth in the period (see Chart 11). Its share in overall GDP rose to nearly 20%,** the highest since the 1960s, when the economy's underlying growth was far higher.

The business investment boom in the late 1980s was spurred by the yen's appreciation (averaging 65% against other major currencies) and the resulting need for labor-saving methods of production. It was fueled by low interest rates and cheap equity finance and supported by soaring profits of Japanese corporations for several years.

The extent of the correction to come is hard to judge. The capital spending/GDP ratio likely must come back down by several percentage points in coming years. This implies either that other demand components will pick up the slack, or that overall GDP growth will disappoint. In the fourth quarter of 1991, investment dropped at a 2.5% annual rate from the third. Thus at least a short-term correction is already under way.

Excess productive capacity has not emerged as a widespread problem. While utilization rates have fallen from the exceptional levels they reached during the boom, the two main measures — based on business managers' evaluations and manufacturing production statistics — are still above levels associated with past slowdowns (see Chart 12).

Chart 10

Disposable income and savings

percent of nominal GNP

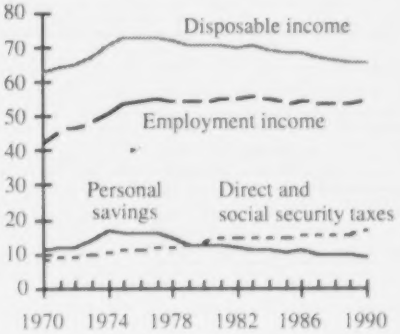


Chart 11

GDP and business investment

percent change on year earlier

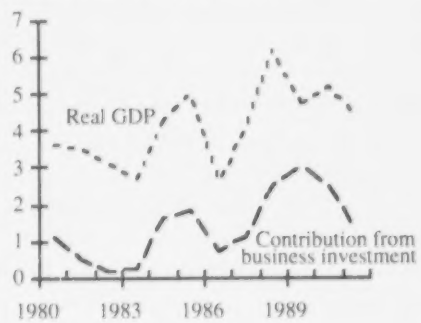
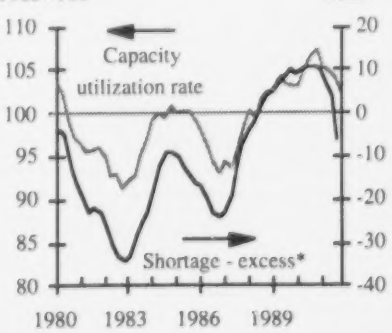


Chart 12

Capacity utilization

1985=100 *index*



*BSI index.

* Higher interest payments contributed to the relative decline of disposable income through 1990, but accounted for only one percentage point of the cumulative drop.

** The ratio would be about one-half percentage point lower absent the NTT and Japan Rail privatizations, but still higher than in any year since 1970 except 1974.

Chart 13

Corporate liquidity

holdings of cash, deposits, and short-term securities; ratio to gross sales, sa

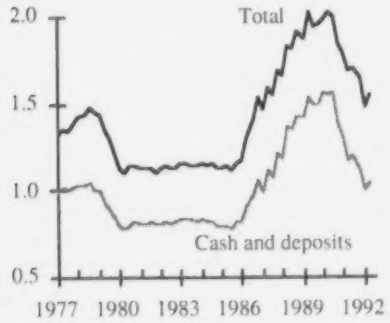


Chart 14

Corporate uses and sources of funds

trillions of yen

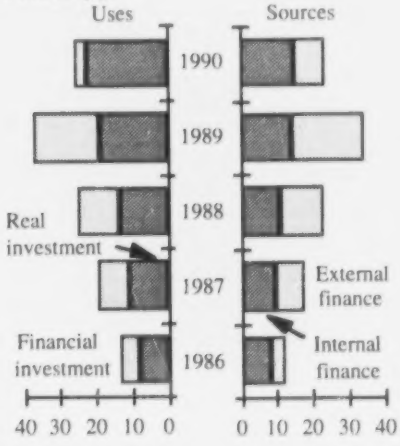
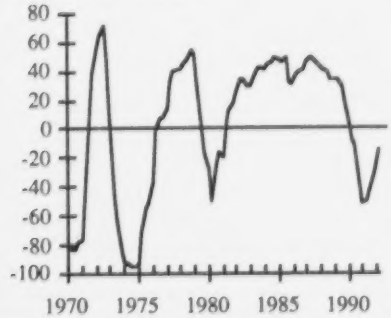


Chart 15

Lending attitude of financial institutions

"easy" minus "tight"



Source: Bank of Japan, Tankan survey.

Funding availability also does not appear a problem for companies wishing to invest. Corporate liquidity remains relatively high by past standards (see Chart 13) even now that many firms have drawn down their financial *zaitech* investments over the past two years.* Starting in 1990 these holdings have been tapped to finance continued rapid growth of real investment, while firms have reduced their reliance on external finance (see Chart 14). Liquidity is unlikely to become a problem even for Japanese corporations carrying large amounts of equity-linked debt.** Perhaps ¥25 trillion of this debt is to mature by the end of 1995, and almost none of the warrant and convertibility features will be exercised unless share prices recover at least 35% from current levels. Refinancing will add to costs and pressure on profit margins for some businesses, but seriously only for certain nonmanufacturing and financial firms. More immediately, scope for further drawdown of corporate financial holdings still exists, although it cannot continue on the scale of 1990 and 1991.

For companies seeking outside funds, lenders' attitudes have eased substantially since last August (see Chart 15). Financial institutions lost enthusiasm for lending in late 1990 and the first part of 1991 — much as they typically have done during economic slowdowns. But now, propelled by the Bank of Japan's monetary easing, they seem eager to lend to their traditional borrowers and long-term prime rates have fallen to around 6%.

With a slim 4% growth in their loan books over the past year, however, banks are not doing much of the new lending. Price incentives continue to push corporate financing away from banks. As one example, commercial paper rates have fallen well below the cost of bank loans for prime borrowers since the fall of 1991. In contrast with 1988, when firms placed the proceeds of CP issuance in financial investments, they may now tap this ¥12 trillion market to fund real business activities. Lending by insurance companies and public institutions both grew 7% during 1991 to ¥61 trillion and ¥98 trillion, respectively, at end-December. While not nearly as large as the banking system, which had ¥460 trillion loans and discounts outstanding at end-1991, these two groups of institutions have traditionally provided a significant offset to cyclical swings in bank lending — and appear to be doing so today.

Altogether, but with the familiar exception of real estate-dependent projects, sluggish growth of lending appears to stem less from inadequate supply than from weak credit demand. The cost of borrowing has risen compared to the abnormal conditions of the late

* Banks encouraged the drawdown by no longer offering CD rates above their own prime lending rates after the fall of 1990 — a pricing change that partly reflected more cautious growth strategies after the 1990 Tokyo stock market crash.

** Japanese firms had an estimated ¥41.5 trillion of equity-linked bonds outstanding at home and abroad as of August 1991. Most of these were issued in 1985-90 at below-market interest cost with the expectation that they would be converted to equity and thus never mature.

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1980s, but it is now low by comparison with earlier periods and thus not, by itself, a major deterrent to investment.

Profitability is the most serious issue for the investment outlook. By the end of last year, profits in relation to sales had fallen from unprecedented highs to their lowest in ten years (see Chart 16). Further declines are likely to be recorded before corporate earnings begin recovering later in 1992.

To the extent that the profit decline is cyclical, it may not curtail investment directly because financing is available from both internal and external sources. Some of the decline, however, may reflect a longer-term drop in real investment returns.* This has not surfaced in the data through 1991, but the probability is high that returns have fallen following the large investments made in the late 1980s under conditions of low capital cost. Over the next several years, therefore, it seems inescapable that private capital spending will grow more slowly than the economy as a whole.

The outlook, to judge from private machinery orders, is that Japan's business investment will fall further. But the downturn is not likely to develop into a sharp decline. Indeed, commercial construction starts, which dropped more than 10% during part of 1991, already have begun to recover (see Chart 17).

* *A capital cost disadvantage for Japan?*, Richard P. Mattione, JPM Advisory-Tokyo, April 1992.

Though manufacturers will cut investments significantly this year, offsets by services-sector increases will leave overall capital spending little changed (see Table 2). Strong demand still spurs investment by transportation, communications, and many private services providers to expand capacity and cut labor costs. Whereas Japanese manufacturers achieved startling increases in labor productivity over the past two decades, services productivity growth has lagged far behind — proof of ample scope for labor-saving investment.

Sectors in the grey area between public and private spending are an important prop for business investment. Electric utilities are one example, already planning expansion of 4%-5% according to first surveys for fiscal 1992. Like the recently privatized telephone and railway companies, these firms' outlays are guided as much by government policy as by profitability. The Miyazawa government recently directed all of these companies to move ahead with substantial investment programs in the fiscal year just begun.

This suggests that the usual pattern will be followed, in which ultimate investments exceed those picked up by surveys taken before the start of the fiscal year. In fact, thanks to low borrowing costs and relatively high capacity utilization in the economy at large, overall capital spending could hold steady even in the face of a substantial drop in manufacturing outlays. Even so, capital spending will make virtually no contribution to economic growth this year. More important, the same forces will hold down

Chart 16

Profits and capital spending

percent

Chart 17

Commercial construction starts

million square meters, sa

Table 2

Capital spending by sector

GDP accounts basis

	% of total	% change from year earlier	
	FY1990	FY91e	FY92f
All industries	100.0	3.9	0.6
Manufacturing	37.3	3.8	-4.5
Nonmanufacturing	62.7	4.0	3.5
Agriculture, forestry, and fisheries	5.8		
Mining	0.2		
Construction	5.1		
Wholesale and retail	10.5		
Finance and insurance	3.3		
Real estate	3.3		
Transport and communications	9.7		
Electric, gas, and water	5.9		
Other services	18.9		

Chart 18

Inventory cycle and industrial production

percent over year ago *1985=100,sa*

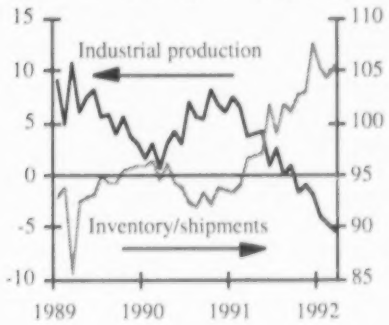

Table 3

Japan economic forecast

percent change

Calendar year	1992	1993
Real GDP	2.7	3.6
Consumption		
Private	2.6	3.2
Government	2.8	2.6
Fixed investment		
Private business	0.8	2.5
Housing	0.4	6.3
Government	6.1	5.0
Contributions to real GDP growth		
Domestic demand	2.2	3.4
Final sales	2.3	3.2
Inventories	-0.1	0.2
Net exports	0.4	0.2
Industrial production	-3.0	3.4
Housing starts (millions)	1.33	1.36
Unemployment rate (%)	2.3	2.2
Inflation		
GDP deflator	1.9	2.0
WPI	-0.4	0.9
CPI-Tokyo	2.4	2.6
Monetary growth		
M2+CDs	3.3	7.5
Balance of payments		
Current account ($ billion)	83.8	88.6
(% of GNP)	2.3	2.2
General government surplus (% of GDP, fiscal year)	2.6	2.9
Net JGB issue (¥ trillion)	7.5	6.5

growth in 1993 and beyond as the economy "grows out of" excessive reliance on private investment.

The inventory cycle and near-term economic growth

In the first months of 1992, inventory correction has led to significant declines in manufacturing output. The correction is sharp, but is a short-term reaction to the rapid stockbuilding that occurred from the second quarter of 1991 and the second-half's final demand weakness. The inventory/shipments ratio at manufacturers reached 107.6 in December, slightly above its peak in the previous two cycles (see Chart 18). Inventories seem to have begun falling following aggressive production cuts since January, suggesting that production may stabilize during the second quarter. The inventory correction is unlikely to be completed until the fourth quarter. Thus growth in production will lag that of final sales throughout 1992 — a lengthy adjustment typical of Japanese business cycles.

Industrial production is forecast to be down 3% for 1992 as a whole (see Table 3). This will be a dramatic contrast to its 5.1% average growth over the past five years. The economy at large will be much less affected. Japanese industrial production and real GDP growth correlate weakly, mainly because producers rarely lay off workers but instead adjust by cutting overtime. Overtime hours are the only labor-related indicator to have weakened significantly in the current slowdown, and have only modest impact on household incomes and confidence.

Monetary and fiscal policy for economic recovery

Since the Bank of Japan (BOJ) began easing monetary policy in May 1991, overnight interest rates have fallen 3.5 percentage points to about 4.75% (see Chart 19 on page 12). Long-term yields and prime lending rates have followed suit, falling three percentage points to date. Adjusted for underlying consumer price inflation of around 2.5%, both short and long-term yields are lower than in past periods of economic slowdown when the BOJ eased policy to spur growth.

Inflation and yen concerns are the two constraints on further Bank of Japan easing. Though the past few years' gyrations of Japanese inflation rates make it hard to set a norm, BOJ officials probably seek consumer price rises of 2.5% or less. With the exception of fresh foods, whose supply is chronically constricted, goods price inflation has moderated in the past year as a result of the industrial slowdown.* More important, and less constructive for medium-term CPI inflation, are ongoing price rises for labor-intensive services. Recently these have edged above 3%, year-on-year, after dipping to around 2.5% in mid-1991 (see Chart 20 on page 12). The stubborn rise of service prices owes much to transportation and distribution bottlenecks, as well as labor shortages in specific

* Outright decline in *domestic* wholesale prices may continue until mid-1992. The *overall* index also fell until recently, as world commodity price weakness and a rising yen depressed import prices, but now is climbing again as the yen has dropped back.

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trades. Some of these problems may be addressed over time by well-targeted private and social investments. In the medium term, however, service prices will remain under pressure as affluent consumers increase their demand for many items that once were considered luxuries.

BOJ easing has not yet revived money growth; indeed, 12-month growth in M2+CDs has shriveled below 2% (see Chart 6 on page 5). Broad liquidity growth has been more stable, thanks in part to deposit shifts from banks to postal savings and other intermediaries (see Chart 21). Both money and broad liquidity have been held down by firms' reluctance to borrow. Now that lending rates are widely perceived to have bottomed, a pickup in borrowing is likely and should eventually show up in more normal growth of at least the broader monetary aggregate.

Failure of a monetary pickup to occur in the next several months could signal a more prolonged slump in final demand than the Japanese authorities now expect. If corroborated by weak real economic data, it would be a reason to look for additional BOJ easing. In the shorter run, further interest-rate cuts are plausible only to avert a potential liquidity crisis, were such to arise from financial market volatility and the effects — real or perceived — of stock price declines on Japanese banks. This risk does not appear major, but the authorities will add liquidity as necessary should the risk become actual.

On the fiscal side, the government has begun addressing the need to rechannel postal savings into private investment, housing, and public works. Loan authorizations for public lending institutions were raised in a supplementary budget for fiscal 1991, and again in an 11% expansion of the Fiscal Investment and Loan program for 1992 (see Chart 22) confirmed in the "emergency" stimulus package of March 31. And by front-loading 75% of public works spending in the first half of the fiscal year, the Miyazawa government virtually committed to proposing another supplementary plan by this fall.

To date, fiscal stimulus has been limited to lending programs and local government public works. Both offer quick and substantial scope: postal savings, which the government can on-lend through public financial institutions, amounted to ¥150 trillion at the end of last year — more than one-third of the banking system's deposits; local governments are important in Japan, equaling the central authorities in public works spending and responsible for three-quarters of all public outlays.

Still, fiscal stimulus has limits by these means alone: public loan expansion presumes private-sector demand; and public works could be threatened by inflationary labor shortages in the construction sector.

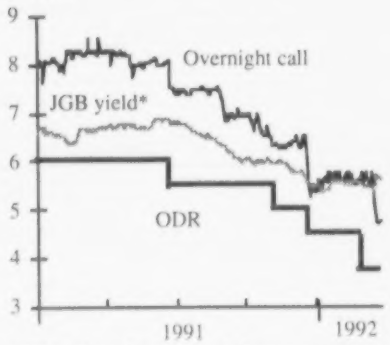
A perennial issue: Japan's underconsuming growth bias

Much of the political impetus behind the 1985 Plaza accord came from Japan's burgeoning trade surplus of the time. For some years thereafter, loose Japanese monetary policy sought to contain

Chart 19

Japan interest rates

percent



*JPM index of actively traded government bonds.

Chart 20

Consumer prices

percent

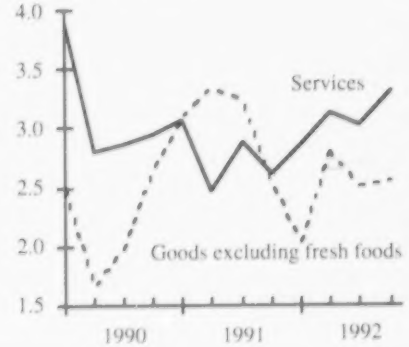


Chart 21

Deposit shift into postal savings

percent change from year earlier

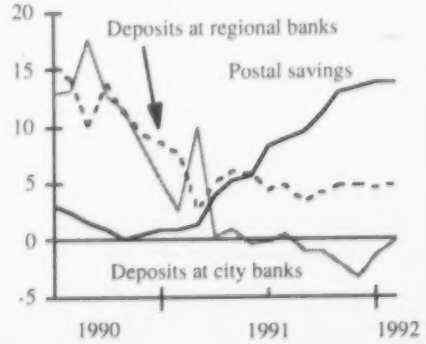


Chart 22

Central government budget plans

percent change from year earlier

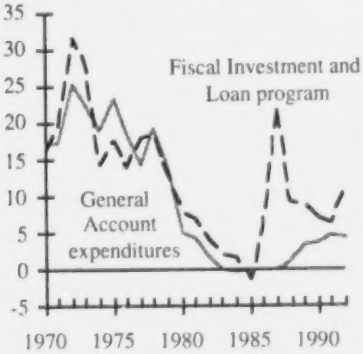


Chart 23

Current account

billions of dollars *percent*

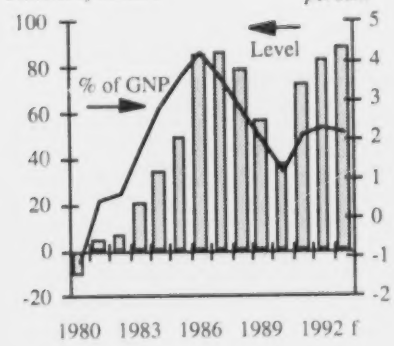


Chart 24

Real effective yen

index, 1980-82=100

upward pressure on the yen but also to steer Japan's economic growth toward domestic demand. The outcome was the late-1980s' financial and economic boom at home, which also enabled remarkable progress in reducing Japan's current account surplus — the surplus fell from 4.3% of GDP in 1985 to 1.2% in 1990.

Chart 23, however, shows that the surplus has since rebounded to 2.1% of GDP in 1991* and may well swell again this year, to some 2.3% of GDP or about $85 billion. Instead of subtracting from real GDP growth, as they did in 1986-90, net exports added 1.4 percentage points in 1991 and will add another half point in 1992.

The growing surplus is not primarily the result of an unduly weak yen, though the currency has weakened this year and stands 13% below its 1988 peak levels in real effective terms (see Chart 24). Still less is it the product of fast-rising exports: goods export volume growth slowed to just 3% amid a sluggish global economy in 1991; it may grow scarcely faster this year or next, even if Japanese firms try to compensate for weakness at home by higher sales abroad. Instead, largely for cyclical reasons, import volume growth slowed drastically in 1991 (to about 3%, from 10% annually in 1986-90) and will lag the export side through most of 1992 as domestic inventory correction runs its course.

* Both the drop in 1990 and the subsequent rise were exaggerated by temporary factors, including special gold imports, J-curve effects, and the Gulf war's impact on oil prices and tourist travel.

The renewed rise in the Japanese trade surplus since 1990 is a short-term cyclical phenomenon, and not necessarily a serious concern. What is of concern is that the long-term problem posed by the Mayekawa report has not been solved; Japan in the late 1980s merely replaced net export growth with an unsustainable bulge in private capital spending. The country once again faces a need to shift the makeup of growth so that it can be domestically rather than externally led, this time with no help from private investment.

Almost by definition, the choices are to boost private consumption, public spending, or both. In fact, the two could be highly complementary in coming years, if land use and social infrastructure improve rapidly enough to support higher domestic consumption growth. This, in fact, is the meaning of a drive toward higher living standards for Japanese citizens, which the government has often pronounced to be its goal.

Yet it is unlikely that fiscal policy can provide adequate support if it remains rigidly focused on the central government deficit, neglects the impact of broad general government activity on the economy, and continues to exclude tax reductions. On this last point, trends in the private sector, such as shorter working hours and more flexible vacations, are helping to support consumption growth, but the rising burden of taxation is a powerful opposing force.

A reason for optimism is the strong fiscal position that the government has achieved in recent years (see

Chart 25). While the central government is running a deficit, the government sector as a whole has been accumulating large surpluses since 1987: including positive savings-investment balances of the local authorities and — more sizably — of the social security fund, the overall surplus rose to 2.6% of GNP in 1989 and 3.6% in 1990. Total public debt — whether measured gross or, more significantly, on a net basis — has fallen smartly (see Chart 26). The net figure is down far below what the "ambitious" aims of the Maastricht Treaty in effect demand of European aspirants to European Monetary Union.* And the ongoing surplus is unique among major industrial countries.

These accomplishments testify to the government's success with its fiscal reconstruction program during the 1980s, as well as some temporary benefit from the recent boom. They will stand Japan in good stead as it faces the need for fiscal policy adjustment to support the post-bubble economy.

It is already clear that the economic slowdown since mid-1991 is reducing government revenues at both central and local levels. The 1980s bubble in tax revenues from capital gains and other *zaitech* income has also disappeared, pointing to more than average negative fiscal impact from this slowdown.

The central government's 1992 General Account budget admitted this to the extent of recognizing the need for some increase in government bond issue, breaking a nine-year streak of reductions under the fiscal austerity program of the 1980s. The Ministry of Finance's latest 5-year fiscal projection has not yet postponed the official target for reducing bond issue to 5% of General Account spending by 1995, but it is already clear that the target will not be met so soon.

Looking further forward, both inflation concerns at home and regard for Japan's relationships abroad argue for a macroeconomic policy mix that will increasingly emphasize fiscal rather than monetary stimulus. This would be a sharp departure from the thrust of the past fifteen years. It may thus require basic re-thinking of the government's policy approach.

Chart 25

Government financial balances

percent of nominal GDP

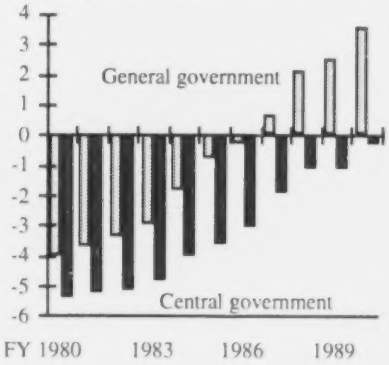
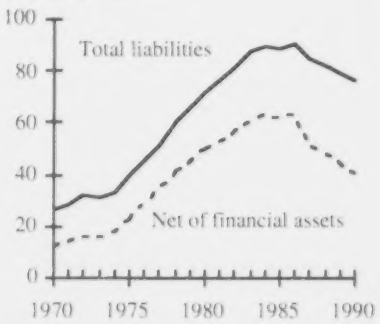


Chart 26

Public-sector debt

percent of GDP

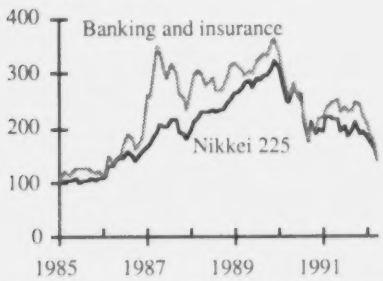


* See "EMU off the Maastricht launchpad," Philip Suttle, *World Financial Markets*, January/February 1992.

Japan's banks: grappling with the past and present

The rise and fall of the Nikkei equity indices

*January 1985=100**



* Latest plot: April 28, 1992 (Nikkei index stood at 17,527 as usually reported).

Table 1

Japanese banks' capital ratios

estimated total risk-based capital ratios percent

	Actual, Sep 1991	If Nikkei index at 20000	17000	15000
City banks	8.80	8.32	7.69	7.26
Long-term credit banks	9.15	8.42	7.79	7.25
Trust banks	10.33	9.10	8.08	7.40
Regional banks (10 largest)	9.45	8.88	8.38	8.04

"BIS" bank capital standards

Risk-based bank capital standards — a joint effort by industrial-country banking authorities under the auspices of the Bank for International Settlements — divide bank capital into two components. Tier 1 (or core) capital is largely equity; it is intended to be a key indicator of the health of a bank. Tier 2 (or secondary) capital consists of such items as subordinated debt, general loan loss reserves, and unrealized gains gauged by marking investment assets to market. The required total capital ratio is 8% of risk-weighted assets, with at least half the minimum as Tier 1 capital.

The standards take effect in 1993 for Japanese banks. Highly pertinent to them, especially after the recent Japanese stock market decline, is the standards' inclusion in Tier 2 of 45% of the difference between market and book values of *equity* holdings.

Principal author: David Mengle, New York

For the Japanese economy to flourish, there must be confidence in the safety and stability of the financial system and the continued availability of credit. Such concerns have returned to the fore this April as bank and insurance stocks fell more steeply than the stock market as a whole (see chart).

Japan's banks (and other financial institutions) are starting to come to terms with past excesses. They have been curbing asset growth (scaling back abroad) and have increased loss provisions in the 1991-92 reporting year. Still, regulatory forbearance will be the main interim solution. It avoids "fire sales" of assets at home or abroad. But it does not spare losses to stockholders, nor does it assure banks a profitable future. For some, consolidation will be the best resolution, and direct government assistance may well prove necessary to this end.

The squeeze on Japan's banks

The fall in banks' stock prices is widely attributed to the decline in the market value of bank equity portfolios, doubts about the banks' ability to meet required capital ratios, and their questionable earnings and balance sheet quality.

In late April, the Ministry of Finance stated that, as of March 31, all but "one or two" of the leading banks met the BIS standards (see box, left). Nonetheless, there is no question that the banks' ability to comply fully is much at the mercy of the stock market (see Table 1).*

Japanese banks book to income their gains on sales of investment securities, including equities. The declines in the Japanese stock market since 1989 leave fewer gains available.

Yet Japanese banks' operating incomes are under pressure, not least from escalating asset quality problems, mostly in real estate. Currently, the Ministry of Finance puts the nonperforming assets of 21 of the leading banks at ¥7-¥8 trillion. A more realistic estimate for the same banks is the ¥21 trillion figure widely attributed to the Bank of Japan. This includes problem exposures through nonbank intermediaries and amounts to 6% of loans outstanding (U.S. banks, reporting more comprehensively, classify 4% of total loans as "nonaccrual").**

Lack of information on Japanese banks' nonperforming assets has contributed to the general uncertainty about their asset quality. Hitherto, nonperformers were not reported publicly, and a loan in de-

* Allowing for capital raised through March 1992, the 31 banks in Table 1 would have needed an additional ¥1.54 trillion capital to meet the BIS 8% total requirement were the Nikkei at 17,000 and as much as ¥3.58 trillion at 15,000. See *Can Japan's banks meet BIS rules?*, Richard P. Mattione, JPM Advisory-Tokyo, and Keiko Mizuguchi, Counterparty Risk Management-Tokyo, April 17, 1992.

** Japanese banks' loans to real estate companies average 185% of equity capital — close to the percentage for construction and nonresidential real estate loans of the 50 largest U.S. bank holding companies.

fault could miss payment for as much as 12 months before going to nonaccrual status. The industry is now moving to a six-month period, but this still would be more generous than prevailing U.S. practice that sets a three-month limit. Further, in Japan, if a borrower makes one payment before the limit, the cycle can begin again. Accrual of income not received obscures the effect of problem loans on operating results.

Coping with reality

Another change that would improve the quality of information available about Japanese banks to their managers and the public is for banks to rely more than hitherto on loan loss reserves as their means to absorb losses. The 21 major banks took a step in this direction by providing ¥0.54 trillion in reserves and write-offs for the 1991-92 reporting year. The negative side of building loss reserves is a charge to income and to equity at the time provision is made; the positive side is that reported balance sheet values move toward realistic economic worth, gauged in principle by present values of expected cash flows. Loss reserves do not change until loans are charged off; by contrast, unrealized gains are tied to the stock market and unlikely to provide much buffer against losses during a general market decline. Despite the advantages, neither tax authorities nor bank regulators encourage setting up realistic loss reserves. Further, loss reserves are set more or less uniformly (and low) at the behest of regulators. This obscures information about individual banks' loan quality, which is useful not just to the public but for interbank risk management as well. Market pressures for improved information as well as more positive official attitudes will be necessary to strengthen Japanese banks' loss provision.

There is some concern that Japanese banks will be forced to sell assets to meet required capital ratios — and particular concern abroad that Japanese financial institutions will liquidate their holdings in overseas markets.

Liquidations have indeed been going on (see Tables 2 and 3) and more will no doubt occur. Yet, though Japanese banks did reduce their foreign securities holdings in 1991, it is unlikely that major gains remain to be realized on a scale that would be much of a cushion against lower earnings from their vastly larger total stock of assets. Besides, if Japanese financial institutions try to take those gains, there will be little effect on world markets: even in U.S. equities and government securities markets, Japanese banks hold only a small fraction of securities outstanding.

In addition, were Japanese banks to focus on overseas assets for reduction, they would lose overseas diversification just as awareness grows of risks *within* Japan. During 1991 alone, external assets of Japanese banks fell 6% and their external liabilities dropped 14%. Their share of global cross-border banking outstandings dropped from 38% in 1989 to 31% in mid-1991. But except where risk-adjusted returns are perceived to have deteriorated, they are not

Table 2
Total assets and foreign securities held by Japanese-owned financial institutions
excluding overseas branches and subsidiaries, year-end, trillions of yen

	1989	1990	1991
Banks			
Total assets	676.4	728.6	730.8
Foreign securities	15.2	18.4	15.9
Life insurance companies			
Total assets	111.2	126.2	139.4
Foreign securities	17.2	17.2	19.9
Postal life insurance			
Total assets	44.8	49.9	56.1
Foreign securities	2.5	2.8	3.2
Casualty insurers			
Total assets	23.0	25.3	27.0
Foreign securities	2.7	3.1	3.2
Securities investment trust companies			
Total assets	57.1	46.0	41.5
Foreign securities	4.8	3.6	5.4
Total of above			
Total assets	912.5	976.0	994.8
Foreign securities	42.4	45.1	47.6
% of total assets	4.6	4.6	4.8

Table 3
Global foreign assets of Japanese banks
year-end, trillions of yen

	1987	1989	1990	1991
Booked in Japan				
Foreign exchange	5	7	10	6
Foreign securities	11	15	18	16
Subtotal	16	22	28	22
Booked in foreign branches				
Cash and due from banks	48	64	67	53
Securities	10	10	10	9
Loans	35	58	75	73
Other	40	44	37	28
Subtotal	132	176	190	163
Total foreign assets	148	198	218	185
Percent of total assets in Japan and overseas	24	23	24	21

A taxpayer bailout for Japanese banks?

Forbearance defers explicit recognition of bank loan losses, but makes them no less real. And because losses reduce banks' taxable income, a formerly abundant tax stream to the Japanese government now may run dry.

To ensure that financial restructuring is not derailed by major defaults, the authorities may need to go beyond accepting this passive loss — say, by giving tax incentives for profit-squeezed large banks to absorb insolvent smaller ones. This may not be a bailout in the sense of liabilities being assumed by an official body, but would have similar fiscal effect: many Japanese financial institutions have had to be kept afloat for years before returning to profit. It should be kept in mind, however, that this fiscal burden does not appear large against the surpluses that Japan's overall public sector has run in recent years.

Bank reform in Japan

Japan's Article 65 (analogous to the U.S. Glass-Steagall Act) bans Japanese banks from certain securities brokerage and underwriting. Unlike in the United States, Article 65 most likely will be liberalized from next year. How far is uncertain: banks may gain authority to underwrite corporate debt and equities through subsidiaries, yet not to broker equities except by acquiring a failing securities firm. Much will depend on the discretion granted by the Diet to the Ministry of Finance.

pulling back disproportionately from overseas to protect domestic positions.*

Plotting a profitable future

The close and protective relationship between Japanese banks, their regulators, and the government suggests that banks will not be forced into drastic or hasty asset sales and charge-offs to meet BIS capital ratios. Some form of forbearance is more probable: a "long-term solution" that defers recognition of losses and allows more time to strengthen capital. Such a course would have the advantage of avoiding the need to boost capital ratios immediately by means of sharp cutbacks in lending or by raising subordinated debt capital on expensive terms.

U.S. experience, however, points to the risk that a long-term solution by forbearance will mean having to deal with the same or greater losses at a later date. Ideally, bank stockholders will absorb all losses while banks rebuild their capital and earnings base; if not, government financial assistance may be necessary to recapitalize the banking industry (see box, upper left).

Another casualty of overreliance on forbearance would be the demand of today's global businesses and investors for financial transparency. By strengthening market discipline, transparency helps confidence in the banking system as a whole.** And for individual banks and their stockholders, its rewards can be tangible — witness the equity market's quick and positive response to the U.S. banks' 1987 set-asides for their LDC claims. If Japanese authorities now move forthrightly toward higher standards of financial disclosure, they have an opportunity to vault past their peers in, say, Germany or Switzerland, where the industry's opaque accounting and disclosure practices conceal much of the information vital to rational assessment of credit quality.

Equally essential to system stability is an enhanced ability for Japanese banks to develop franchise value and consistent operating profits in a market in which customers have far more alternatives than in the past.

Three avenues of improvement come to mind. One lies in ongoing deregulation (see box, lower left) to allow the banks into new areas of financial service. The second is for banks to pay more attention than in the past to credit quality and cost control to beef up interest margins.

The third envisages a degree of longer-term shrinkage in the financial sector. Some consolidation of banking firms will have to take place in order to encourage less aggressive loan pricing along with reduction of costs from duplicate facilities. Past experience suggests that consolidation will not occur rapidly — but is a logical outcome of recent pressures on earnings.

* Note that so long as Japan is in current account surplus, it definitionally exports capital on a net basis to the rest of the world, whether or not Japanese banks intermediate the cross-border flow.

** Confidence also is vital at the retail level. Individual bank deposits in Japan are insured up to ¥10 million ($75,000). The average Japanese household owns more than ¥11 million in deposits and insurance assets. This underscores the importance of the government's implicit guarantee that institutions that solicit investments from *individual savers* will not be allowed to default. Indeed, no liquidations and only two assisted takeovers have occurred in recent memory.

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Global economic outlook in summary

percent change from previous year, except as noted; group averages and totals are for countries listed

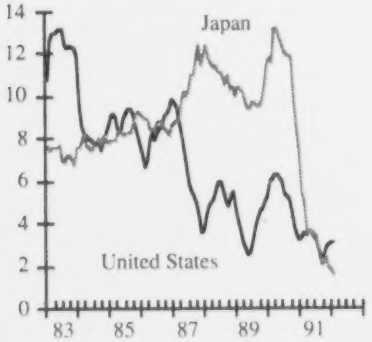
	Nominal GDP/GNP	Real GDP/GNP			Consumer prices Dec-Dec			Current account $ billions			% of GDP/GNP		
	$ billions, 1991	1990	1991	1992	1990	1991	1992	1990	1991	1992	1990	1991	1992
Industrial countries	16555	2.5	1.0	1.6	5.2	3.6	3.3	-90.2	-17.5	-37.2	-0.6	-0.1	-0.2
United States	5673	1.0	-0.7	1.7	6.2	3.0	3.0	-92.1	-8.6	-40.8	-1.7	-0.2	-0.7
Canada	593	0.5	-1.5	0.8	5.0	3.8	3.6	-19.0	-23.4	-23.1	-3.3	-3.9	-4.0
Japan	3225	5.2	4.4	2.7	3.5	2.9	2.3	35.8	72.6	83.8	1.2	2.2	2.3
Australia	301	1.7	-2.0	3.0	6.9	1.5	3.4	-14.5	-10.1	-9.9	-4.8	-3.3	-3.4
Western Europe	6763	2.8	1.1	1.1	5.1	4.6	3.9	-0.4	-46.5	-44.3	-0.1	-0.7	-0.6
Germany	1573	4.7	3.2	0.5	2.8	4.2	3.3	44.7	-21.5	-10.6	2.9	-1.4	-0.7
France	1190	2.8	1.5	1.7	3.4	3.1	2.8	-8.4	-5.3	-5.2	-0.7	-0.4	-0.4
Italy	1132	2.2	1.4	1.3	6.4	6.0	5.2	-14.6	-20.6	-22.7	-1.3	-1.8	-1.9
United Kingdom	1035	1.0	-2.3	0.9	9.3	4.5	4.6	-27.5	-7.8	-17.3	-2.8	-0.8	-1.6
Belgium	205	3.4	1.6	1.6	3.5	2.8	3.2	5.0	3.8	4.2	2.5	1.9	2.0
Denmark	129	1.6	1.0	1.5	1.9	2.5	2.5	1.5	2.2	1.5	1.2	1.7	1.2
Finland	135	0.0	-6.2	-2.0	5.3	3.9	4.8	-6.7	-5.2	-2.6	-4.9	-3.8	-2.1
Netherlands	276	3.4	2.0	1.6	2.6	4.9	3.7	9.9	10.6	12.0	3.6	3.9	4.3
Norway	107	1.8	2.5	2.0	4.5	3.5	3.5	3.6	5.4	4.5	3.4	5.3	4.4
Spain	516	3.6	2.4	2.7	6.5	5.6	5.7	-15.7	-16.0	-17.6	-3.6	-3.1	-3.3
Sweden	235	0.3	-1.5	-1.0	10.8	7.9	3.0	-5.4	-2.8	-2.0	-2.4	-1.2	-0.8
Switzerland	229	2.2	-0.5	0.5	5.3	5.2	3.0	8.6	8.9	8.6	3.8	3.9	4.1
Emerging markets	2923	3.3	3.9	4.4	443	85.7	62.6	1.0	-16.6	-36.3	0.2	-0.6	-1.1
Europe	402	0.9	1.1	3.5	77.4	44.6	39.1	-6.4	-2.6	-3.6	-1.5	-0.6	-0.8
Greece	71	0.5	1.0	0.7	22.8	17.8	15.0	-3.6	-1.5	-2.0	-5.2	-2.1	-2.5
Portugal	68	4.4	2.7	2.5	13.7	9.6	9.7	-0.2	-0.7	-1.2	-0.3	-1.0	-1.7
Turkey	114	9.7	0.3	5.5	60.4	71.1	60.0	-2.6	0.3	0.3	-2.4	0.3	0.2
Czechoslovakia	37	0.0	-12.5	-6.0	18.4	53.0	19.5	-1.0	0.4	0.5	-2.1	1.0	1.3
Hungary	33	-3.4	-8.5	-3.1	33.4	34.5	26.1	0.3	0.3	-0.2	0.8	0.8	-0.5
Poland	80	-12.0	-10.0	-3.0	249	60.4	70.0	0.7	-1.4	-0.9	1.1	-1.7	-1.1
Latin America	1015	-0.2	3.2	3.0	1231	216	153	-2.6	-13.4	-23.9	0.0	-1.3	-2.0
Argentina	133	0.4	4.5	5.0	1344	84.0	25.0	1.8	-2.9	-4.0	1.7	-2.2	-2.6
Brazil	403	-4.3	1.2	1.5	1585	475	350	-2.2	-2.4	-0.5	-0.5	-0.6	-0.1
Chile	31	2.1	5.7	6.0	27.3	18.7	20.0	-0.8	-0.3	-1.6	-2.8	-0.9	-4.6
Colombia	43	4.2	2.2	2.6	32.4	26.8	22.0	0.3	2.5	0.8	0.8	5.8	1.9
Ecuador	12	2.3	2.9	2.3	49.5	49.0	57.0	-0.1	-0.3	-0.2	-1.3	-2.1	-1.6
Mexico	286	3.9	4.4	3.8	29.9	18.8	13.0	-6.3	-11.1	-16.0	-2.7	-3.9	-4.8
Peru	55	-4.3	2.4	3.0	7649	139	60.0	-0.7	0.0	-0.9	-1.7	-0.1	-1.4
Venezuela	53	5.7	9.2	3.5	36.5	31.0	32.0	8.0	1.1	-1.5	16.3	2.0	-2.6
Asia/Pacific	1506	6.4	6.2	6.3	7.6	8.5	7.7	10.0	-0.6	-8.8	0.8	-0.1	-0.6
China	366	5.1	7.2	8.0	2.2	5.5	7.0	12.0	13.0	10.2	3.2	3.6	2.5
India	262	5.0	2.5	2.5	13.7	15.5	10.5	-8.8	-6.5	-5.8	-3.0	-2.5	-2.3
Hong Kong	82	2.4	3.8	5.5	11.3	10.3	10.0	9.7	7.0	4.5	13.8	8.5	4.7
Indonesia	104	7.4	6.0	5.5	9.4	9.9	8.5	-2.4	-5.3	-5.1	-2.2	-4.5	-3.3
Korea	238	9.3	8.4	7.5	9.4	9.6	9.2	-2.2	-10.0	-8.7	-0.9	-3.7	-2.8
Malaysia	43	9.8	8.8	7.5	3.3	4.2	4.8	-1.7	-4.4	-5.3	-3.9	-9.1	-9.6
Philippines	44	3.9	-0.1	2.5	14.2	12.3	9.5	-2.7	-1.0	-1.4	-6.1	-2.2	-2.7
Singapore	36	8.3	6.7	5.7	3.8	2.9	3.2	2.4	4.2	3.3	6.9	10.6	1.2
Taiwan	162	5.0	7.0	7.5	4.6	4.4	4.0	10.8	10.5	7.8	6.7	5.8	3.8
Thailand	80	10.0	7.9	7.5	6.6	4.7	5.2	-7.1	-8.1	-8.3	-8.8	-8.9	-8.3

G-7 broad money

percent change from year earlier

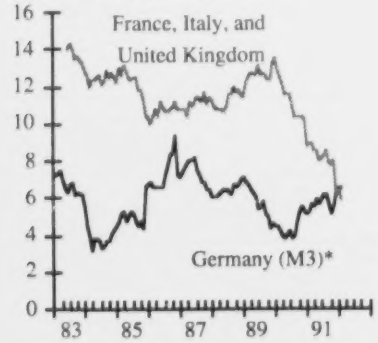
U.S. and Japanese M2

percent change from year earlier



European broad money

percent change from year earlier



* 1990-91 adjusted for unification.

Global economic outlook

Economic growth and monetary trends. The Tokyo stock market debacle focuses attention on economic weakness outside the United States.

- As the U.S. economy begins a still tentative recovery, adjustment in Japan and tight policies in Europe render G-7 economic growth rates more convergent now than at almost any time in the past three years.
- Low nominal GDP growth both mirrors and engenders low G-7 monetary growth. The latter has halved since the late 1980s and still is not accelerating.
- Minimal monetary growth is most conspicuous in Japan; but the past year's spectacular reversal of the late-1980s slide in monetary velocity mutes negative consequences for the economy.
- Germany's above-target monetary growth now exceeds the rest of Europe's. This is less a pointer to imminent pick-up in nominal activity in Germany than a testament to Europe's overall disinflation.

Inflation. Weak monetary growth, excess capacity in most product markets, and generally declining commodity prices all restrain global inflation.

- Inflation is the main policy concern only in Germany, where the painfully slow 1992 wage round and strong domestic credit expansion are keeping the authorities on edge.
- Short-term interest rates are unlikely to fall much further in the United States and Japan. Some reductions remain likely in Europe later in 1992. More will follow in 1993 — including in Germany.

Emerging markets. Hints of economic growth convergence are surfacing as laggards begin to reap the harvest of steadfast market-oriented reforms and established high-flyers push up against home and global market limits.

- However belatedly, Brazil is moving to accelerate basic reforms. Latin America at large is riding the return of flight capital and foreign investor interest. Its growth has not been severely undercut by global economic weakenss and can only gain from the U.S. recovery.
- Many East and South-East Asian NICs show signs of cooling, and are more vulnerable to any unexpected weakness in Japan.

Russia. Yeltsin's price liberalization and privatization go forward amid general confusion. Unless seen to deliver a few positive results later this year, they will be challenged afresh from within or without parliament.

- Tangible Western support remains crucial for Russia's reform effort; even so, a ruble "stabilization fund" looks premature and alternatives hard to mount amid the West's own domestic fiscal pressures.

The Americas

United States. Economic activity held up better in the first quarter than once seemed likely. Although industrial production fell over 4% (saar), final demand delivered a 5% gain in consumption and 2% in overall GDP.

- Consumers have taken advantage of retail discounting and healthy post-tax income gains. But further strong gains in consumption are doubtful: consumer debt still weighs heavily and the savings rate is unlikely to drop from its current 4.9%.
- If economic growth is to revive from the lackluster 1.4% pace of the past year, hiring will have to pick up in the months ahead. Yet even this will not avoid a further rise in the unemployment rate to some 7.5% by midyear.

Defense cutbacks and the commercial real estate overhang are enduring drags on the economy. Financial-sector retrenchment is another, less quantifiable, risk to activity.

- The Federal Reserve remains focused on M2. So long as this stays close to its target floor, a further easing cannot be ruled out.

Canada's employment has dropped five months in a row, taking joblessness above 11%; auto sales, housing starts, and orders hint no imminent upturn; and only a moderate boost will come from the U.S. export market.

- To revive the economy, the odds favor further monetary easing.

Latin America. Low U.S. interest rates and fevered search for "the next Mexico" by both local investors and many abroad have abruptly reversed Latin America's long-standing capital flight and low esteem internationally. Funds have deluged laggards, as well as leaders, in economic reform.

- The predominantly "hot money" nature of the inflows may do little to increase productive investment. And, as Latin America knows well from its past, the large-scale reserve increases recently experienced threaten domestic monetary indiscipline and currency overvaluation.

United States: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991	1992				Q4/Q4 change	
	1992f	1993f	Q4	Q1f	Q2f	Q3f	Q4f	1992f	1993f
Real GDP	1.7	2.8	0.4	2.0	2.0	2.0	3.0	2.2	3.0
Private consumption	2.6	2.6	-0.0	5.3	2.4	2.0	2.7	3.1	2.7
Business fixed investment	-2.9	3.6	-3.4	-1.5	-6.8	-0.8	2.6	-1.7	6.5
Residential construction	10.9	5.3	12.3	9.8	15.8	6.0	3.1	9.1	5.2
Inventories*	-0.0	0.5	0.6	-2.8	0.4	0.6	1.0	-0.2	0.3
Net exports*	0.2	-0.0	0.8	0.3	0.6	0.2	-0.1	0.2	-0.1
Consumer prices	3.0	2.9	3.6	2.8	3.2	3.2	2.8	3.0	3.0
Civilian unemployment rate (%)	7.4	7.2	7.0	7.2	7.5	7.5	7.4		
Trade balance FAS/CVB ($bil.)	-53	-59	-66	-58	-51	-51	-52		
Current account ($bil.)	-41	-40	-41	-46	-40	-39	-39		

* Percentage-point contributions to real GDP growth.

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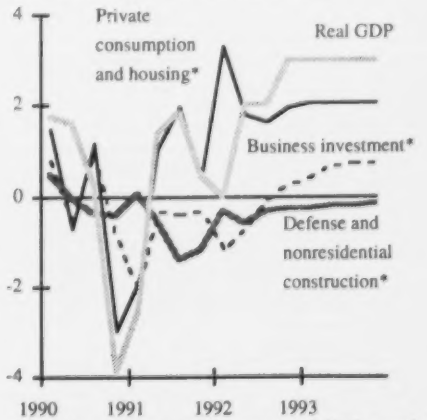
U.S. real GDP

percent change quarter over quarter, saar



* Percentage point contributions to real GDP growth.

U.S. domestic nonfinancial debt

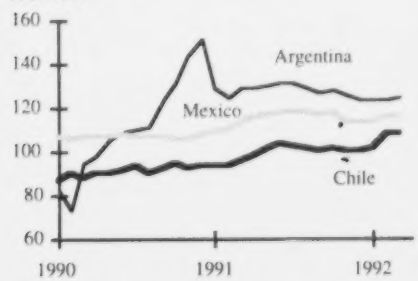
U.S. domestic nonfinancial debt

year-end, percent change from year earlier

	1989	1990	1991
Total	7.7	6.5	4.3
Federal	7.0	11.0	11.1
Non-Federal	8.0	5.1	2.3
Household	9.7	7.4	4.1
Home mortgages	10.3	9.3	5.1
Consumer credit	5.8	1.8	-2.0
Business	6.8	2.8	0.1
Short-term	8.4	3.4	-5.0
Long-term	5.9	2.5	3.3
State and local government	8.4	5.2	2.8

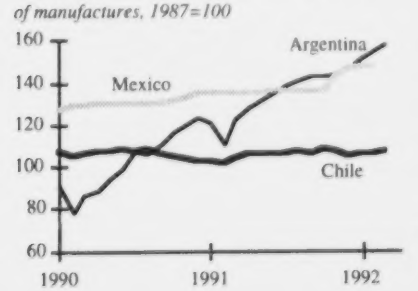
Real effective exchange rates

1987=100



Domestic terms of trade

ratio of consumer prices to wholesale prices of manufactures, 1987=100



Minimal U.S. borrowing pressures

Apart from worry that Japanese investors may pull back from demand, the nightmare of U.S. debt markets is issuance pressure on supply. The nightmare is fed by increased federal borrowing: a deficit of $350 billion means 12.5% growth this year in total Treasury and agency debt outstanding. Yet, however worrying the federal debt appetite may be for the economy's long-term health, its lion's share of credit issuance more immediately reflects the weakness of issuance by all other sectors of the U.S. economy — which collectively handily outweigh the Federal presence in the U.S. debt picture.

From a 1985 peak of 14.5%, growth in non-federal debt outstanding fell away to just 2.3% during 1991. Business outstandings were virtually unchanged, a small pickup in long-term debt growth being counterbalanced by lower short-term borrowing. There has, certainly, been an increase in corporate bond net issuance — but to nowhere near the pace amid the leveraging frenzy of five years ago — and a very welcome rise in equity issuance. Both reflect less an underlying demand for funds than balance sheet restructuring and maturity lengthening. The trailing off of such restructuring may depress corporate debt demand in the quarters ahead, even into the eventual upturn in business investment.

Likewise, state and local governments as well as households have curbed their debt appetites — the former cowed by recession, the latter with precautionary reasons prominent amid job worries and problematic home equity valuations. Today's sobered price expectations for homes (not to mention commercial property) and moderate interest rates support mortgage refinancing, but do not suggest that net mortgage credit will rise smartly with housing activity.

Thus overall nonfinancial credit demand is set to stay subdued for quite some time, thanks also to the high level of debt still outstanding as a legacy of 1980s' excess. That legacy is a major reason to anticipate economic recovery that continues mild, one that in turn keeps down supply pressure on the debt markets.

Exchange rate "Dutch" disease in Latin America?

Though Latin America's reforming vanguard — Chile, Mexico, and Argentina — can expect historically moderate 13%-30% inflation this year, their inflation containment has wrought major changes in *relative* prices, both domestically and vis-à-vis the outside world.

Relative price changes signal investors concerning the prospective profitability of investment in different sectors. The term "Dutch disease" recalls the 1970s' Netherlands' experience of profit compression in manufacturing under the relative price changes bred by natural gas development. The disease propagates readily when overall inflation control is disproportionately enforced by real exchange rate appreciation — conspicuous now in Argentina (since 1989 and sustained by the peso's fixed dollar rate), prominent in Mexico (since late 1990), and noticeable in Chile (in the past year). Strong currencies have been favored in the region to fight inflation expectations. And they come to look sustainable while capital floods in from abroad amid financial investor euphoria. Latin America's own previous history, however, shows that the economic consequences may be less benign in the medium term (and the currency strength ultimately untenable). Particularly troubling in this connection are the steep rises apparent in Argentina and Mexico in the terms of trade of domestic services sectors relative to manufacturing. The positive interpretation is that these illustrate the constructive power of competition through trade liberalization; the negative is the effective twist of investment incentive toward service activities sheltered from international competition, to the progressive enfeeblement of tradables output that will lead to eventual external payments problems.

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Europe

Germany. The pickup in first-quarter output to be reported for western Germany will have been mostly a statistical phenomenon of leap year, the weather, and the construction sector. Rather than a genuine improvement in economic conditions, it will give way to renewed stagnation.

- Consumption should improve as the year proceeds but will bring neither business prosperity nor a shrinking budget deficit. Indeed, later in the year, with unemployment and future tax liabilities rising, German consumers may no longer feel their own fortunes rising.
- Western and eastern Germany have now traded places in their overall economic fortunes. While the west stagnates, government-led construction is finally pushing GNP up in the east: an impressive-looking 10% growth is in prospect for 1992 as a whole. The revival in the east is the key factor buoying Germany-wide M3 and credit growth.

Elsewhere in Western Europe, there are no clear signs of revival on the Continent. While the commitment to the EMS remains absolute, there is now greater willingness to adopt expansionary fiscal policies, especially in an effort to head off domestic political discontent.

- The suprisingly decisive U.K. election result, combined with its very stimulative fiscal policy, should bring clear signs of recovery in coming months — just as the United Kingdom led Europe into recession, so will its economy be the first to spring out.

Central Europe. Deep recessions and looming heavy outlays for financial restructurings are swelling fiscal deficits throughout the region.

- To achieve less inflationary financing, Czechoslovakia and Poland are speeding local securities market innovation.
- To tackle revenue structure and collection deficiencies, Hungary is tightening its VAT, Czechoslovakia plans one for January 1993, and so does Poland later next year.
- Innovation and restructuring do not signal quick economic revival.

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Susanne Gahler, Apr 21

Europe: real GDP forecast

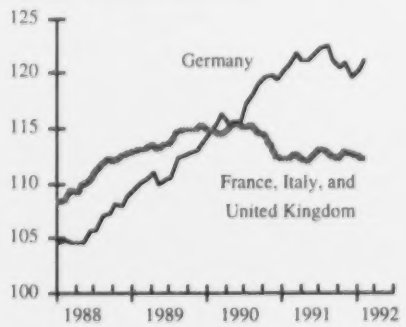
seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1991	1992			Q4/Q4 change		
	1991f	1992f	Q4	Q1f	Q2f	Q3f	Q4f	1991f	1992f
Major 4	1.0*	1.1*	-0.6	2.2	0.8	1.5	2.2	0.6	1.9
% change over year ago			0.6	1.0	0.8	1.1	1.0		
Western Germany	3.2	0.5	-1.8	5.7	-2.7	-0.8	0.4	0.9	1.2
% change over year ago			0.9	0.4	-0.1	0.4	1.2		
France	1.5	1.7	0.2	1.6	1.6	2.0	2.0	1.8	1.8
% change over year ago			1.8	1.9	1.6	1.4	1.8		
Italy	1.4	1.3	0.8	0.8	1.6	2.8	4.0	1.3	2.4
% change over year ago			1.3	0.9	0.9	1.5	2.4		
United Kingdom	-2.3	0.9	-1.2	-0.4	3.6	2.8	2.8	-1.7	2.3
% change over year ago			-1.7	1.0	0.8	1.4	2.3		

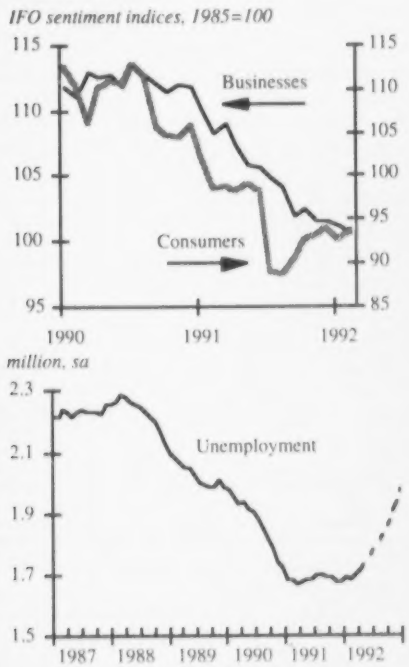
* All Western Europe, except Austria, Greece, Ireland, and Portugal.

Europe: output stagnation

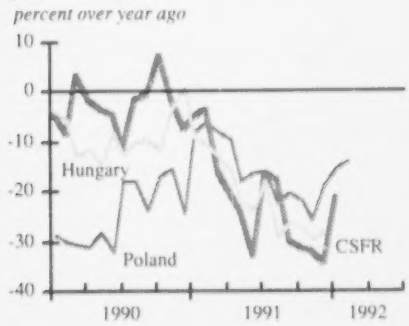
industrial production, 1985=100



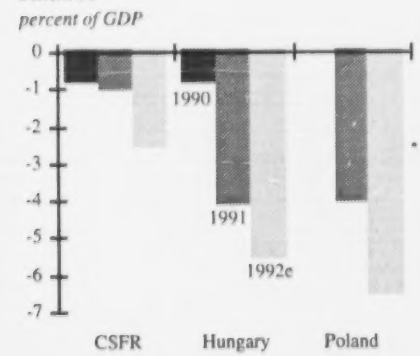
Western Germany: confidence and unemployment



Central Europe: industrial production



Central Europe: central budget balance



Western Germany: weakness shifts from consumers to the business sector

The forces slowing the western German economy are shifting. The tax hikes in the middle of 1991 took the steam out of consumption at the same time that demand from the east was tailing off: combined, these effects caused a sharp drop in the demand for consumer goods. The immediate future is more encouraging for western consumers. Real wages are rising significantly: wage settlements average close to three percentage points above the inflation rate; and from July 1, the one-year "solidarity surcharge" — 7.5% of an individual's tax liability — is set to expire, boosting real disposable incomes by about 2.5% in the second half of the year relative to the first.

The counterpart to consumers' gains is a deteriorating outlook for business. In the past two years, high and rising profitability spurred a 24% rise in equipment investment. This, in turn, was the key ingredient of above-potential growth. Now, by contrast, profits are being squeezed from all sides: higher wage costs; higher environmental levies; reduced government subsidies; falling productivity; and a still-strong DM.

There are signs that German companies not only are tempering their overall investment plans for 1992, but also are increasingly considering capacity expansion outside Germany — a decision that would dampen longer- as well as short-term economic growth at home. In due course, corporate domestic retrenchment will show up as declining employment — indeed, hiring already has stalled, and unemployment has begun to edge higher. A more decisive move upward is due before year-end — and could undermine any short-term consumer optimism engendered by the approaching mid-year tax cuts.

Poland: stabilization and market reforms in peril

First in Central Europe to apply stabilization shock therapy and radical market reforms, Poland now could be first to call a halt. Over the next few weeks, the parliament must choose between continued stabilization (and a likely third consecutive year of falling output) or attempted recovery at the risk of increased inflation and external imbalances. Though the political mood points to the latter course, continued fiscal austerity may yet win the day so as to safeguard stabilization gains to date and assure the external resources and financing on which Poland is critically dependent.

Chief among stabilization achievements are continued confidence in the zloty and the inflation downtrend (to 11.6% for the first quarter of 1992) — the former despite its "crawling peg" and two devaluations in the past year, the latter despite price hikes on the few remaining administered prices. But the necessary and hard-won restraint of money and credit (which saw broad money fall 8% in real terms in 1991) has cut domestic demand and industrial output sharply, pressured too by import competition. Unending output declines could eliminate not only unproductive activities, but also some that are potentially viable over time. Meanwhile, the smallish private sector, mostly concentrated in trade and services, is unable to absorb ever-growing layoffs from the state sector. Unemployment has reached 12%. Were it to reach the proportions seen in eastern Germany (where unemployment, both open and disguised, reached 25%), political resistance could derail Poland's reform effort.

Traditional budgetary easing, however, is no answer. As elsewhere in Central Europe, recession in Poland is shriveling tax revenues and heightening the financial risks of fiscal expansion. Besides, industrial revival is more than just a matter of credit or demand stimulus. Equally important is the relief of supply bottlenecks and the upgrading of technology and management — matters in which continued access to Western resources, know-how, and markets offers the only viable way forward.

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Asia/Pacific

Japan. The latest economic data have been mixed: unemployment remains a low 2% and housing exhibits clear signs of recovery; but industrial production and imports have weakened further, and business capital spending is being scaled back for now.

- Recent readings probably mark the low point in the inflation cycle.
- Yen weakness against the dollar points to rising import prices in the months ahead.
- Inflation is under control, but labor markets remain tight and the spring wage round still is producing gains close to 5%.

Prospects of reviving economic growth later in 1992, a more expansionary fiscal policy, and limited further progress on inflation suggest that longer-term yields — now the lowest in major financial markets — must rise.

Australia. CPI inflation can hardly stay as low as the year-on-year 1.5% recorded in the final quarter of 1991. This was helped by lower housing costs and oil prices, leaving the underlying rate close to 3.5%. The overall rate should not drift much above 3%-4% in the year ahead: muted economic recovery, the stable currency, and still-high unemployment should cap both demand-pull and cost-push pressures.

- The main risk to inflation is that policies could over-stimulate. With a year to elections, the onus is on the Keating government to revive growth. February's stimulative fiscal package should soon be boosted by a further half-percentage-point easing in short-term rates, to 7%.

Asia/Pacific NICs. Highly respectable growth, combined with some easing in inflation pressures, still characterize the region.

- Spillover effects of any sharper-than-expected slowing in Japan are likely to be most significant in this region. Japan's trade surplus with Asia already has doubled in the past two years.

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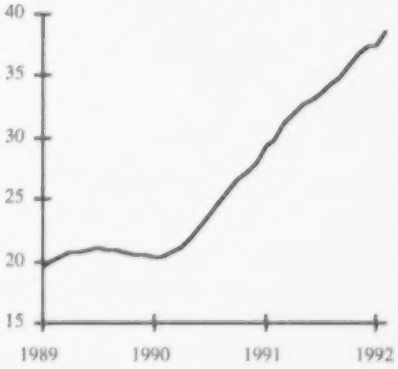
Japan's trade surplus with Asia
latest 12 months, billions of dollars



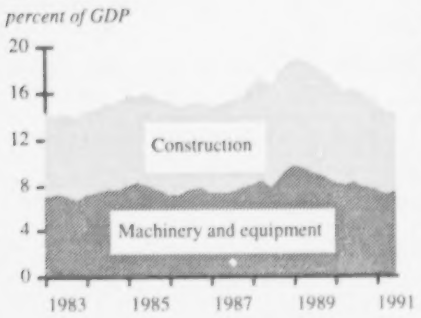
Japan: economic forecast
seasonally adjusted annual rates, percent change quarter over quarter, except as noted

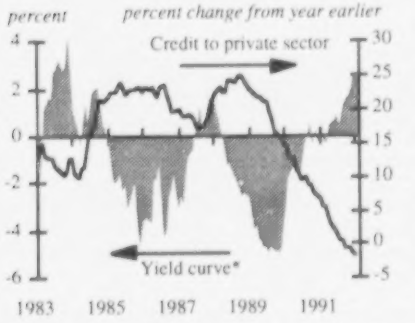
	1992f	1993f	1991 Q4	1992 Q1f	Q2f	Q3f	Q4f	Q4/Q4 change 1992f	1993f
Real GDP	2.7	3.6	0.1	3.1	3.2	4.9	2.6	3.4	3.8
% change over year ago			3.1	2.2	2.0	2.8	3.4		
Private consumption	2.6	3.2	0.4	0.6	4.6	3.9	3.7	3.2	3.2
% change over year ago			3.0	2.6	2.2	2.4	3.2		
Business fixed investment	0.8	2.5	-2.5	12.8	-11.6	3.8	-0.6	0.7	3.0
% change over year ago			1.5	2.4	0.0	0.2	0.7		
Residential investment	0.4	6.3	-18.4	34.6	0.0	2.5	-8.5	6.5	6.0
% change over year ago			-14.7	-6.5	0.0	3.0	6.0		
Inventories*	-0.1	0.2	-1.3	-0.1	-0.5	1.9	-0.4	0.2	0.3
Change over year ago			0.1	-0.2	-0.3	0.0	0.2		
Net exports*	0.4	0.2	2.2	-2.1	2.2	0.2	1.0	0.4	0.3
Change over year ago			1.1	0.2	0.6	0.8	0.4		
Consumer prices (Tokyo, %oya)	2.4	2.6	3.2	2.1	2.6	2.6	2.3	2.3	2.6
Trade balance (customs, $bil.)	87	88	90	113	78	81	76		
Current account ($bil.)	84	89	86	101	73	73	88		

* Percentage-point contributions to real GDP growth.

Japan: real GDP
percent change over year ago

Australia: investment boom and bust





* Yield on 10-year Treasury bonds less yield on 90-day Treasury bills.

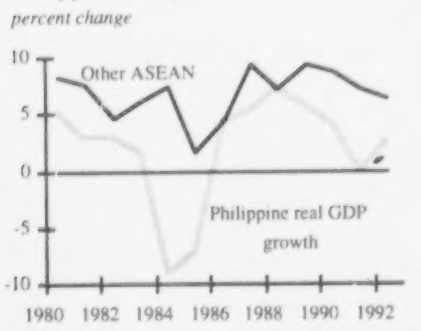
Australia: a credit crunch extreme

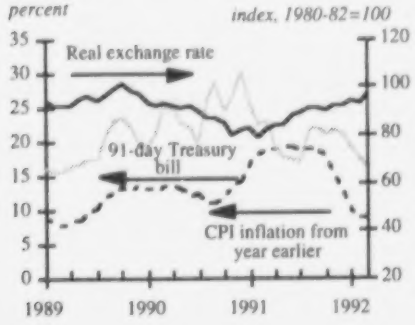
If Japan is the prime example of a soft real economy landing after an asset-price boom and bust, Australia's experience is the polar opposite among OECD countries. Investment topped out at nearly 19% of real GDP early in 1989, almost 5 percentage points above its 1983 low, and contributed mightily to 4.8% annual real GDP growth over the period. Investment now is nudging the 1983 low again; it dropped 13% in 1991 and could shrink up to half as much again in 1992.

The 1984-89 investment boom was fed by surging profits (helped by falling real wages), financial deregulation, and soaring asset prices. A marked acceleration of price inflation in 1988 precipitated abrupt tightening of the monetary screws. Unlike an earlier tightening in mid-decade that likewise had inverted the yield curve sharply, late-1980s' restraint triggered a protracted credit crunch. Bearing in mind the high leveraging of much Australian business, it is impossible to sort out definitively the respective roles of credit demand weakness and lenders' prudential constraints in this crunch. More important, despite Reserve Bank easing that has taken 3-month rates from 18% in late 1988 to a recent 6.8%, the crunch is not yet over in the aggregate; hence the government's "One Nation" decision in February for microeconomic reforms plus fiscal expansion, including investment incentives, public works, and somewhat higher family allowances.

The reforms and incentives are unlikely to provide much macroeconomic zip right now. Still, the spending measures should shore up consumption (which prior to weakening last summer under the weight of unemployment had broadly held to the 4% growth trend set during the boom). Firming consumption, a modest revival in housing, and an end to rural drought (which is delivering a positive net export trend) point to moderate economic recovery this year for Australia — but hardly one that is investment-driven.

Philippines: stagflation





Philippines: still the laggard in ASEAN

President Corazon Aquino leaves office after May's national elections and a mixed economic record. Across the Aquino years as a whole, Philippines real GDP, export, and investment growth, not to mention price stability, have been markedly inferior to the performance of its dynamic ASEAN partners — indeed, no better than in the Marcos period.

Operating far under capacity and bankrupted under Marcos, the economy at first turned in 6% annual real GDP growth under Aquino. But this growth was consumption-led. Then 1989-90 brought balance of payments and debt management difficulties, the prospective rundown of U.S. military facilities (and related economic assistance), natural disasters, and continued political instability.

Adjustment via monetary and fiscal austerity has not been easy, steadfast, or speedy. The cost, in a stagnant global economy, was shrinking domestic activity last year with prospects for only 2%-3% growth in 1992. Aided by peso depreciation early in 1991 and low oil prices, however, austerity has paid off in a reduced current account deficit, better relations with the IMF and other creditors, and inflation less than half the 19% peak of last summer. Also, major steps have been taken to improve revenue and other administration; speed privatization; and liberalize trade, foreign exchange and investment rules. With nominal interest rates falling but real rates quite positive, capital inflows have driven up the peso exchange rate this year.

Confidence could shrivel if the current account deficit balloons with economic recovery or, more worrying, if indecisive elections lead to the loss of macropolicy discipline. Most crucial for realizing the Philippines' economic potential after decades of disappointment will be follow-through on the structural initiatives launched in the past two years under Aquino — with emphasis now on the energy bottleneck, domestic pricing, and the financial system.

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Effective exchange rates

*index numbers, 1980-82 average = 100**

	1989	1990	1991	1991 Q1	1991 Q2	1991 Q3	1991 Q4	1992 Q1	1991 Mar	1991 Nov	1991 Dec	1992 Jan	1992 Feb	1992 Mar
Nominal against 15 industrial-country currencies														
United States	91.3	86.5	85.5	81.7	82.8	87.7	87.6	84.0	82.2	86.1	85.3	83.8	82.8	83.0
Japan	172.8	156.8	170.0	168.5	165.9	167.6	170.4	175.3	165.2	171.2	175.7	175.0	175.1	179.7
Canada	100.5	100.7	102.5	100.0	100.7	102.8	103.3	103.2	100.4	103.5	104.3	103.6	101.7	100.8
Australia	65.6	62.4	61.5	59.0	59.6	62.3	63.2	61.0	59.3	63.2	62.7	61.2	59.0	57.2
Germany	121.0	124.9	124.2	125.8	125.7	122.9	123.4	125.0	125.9	124.0	124.0	125.1	125.9	125.6
France	84.9	88.2	86.8	88.8	87.7	86.2	86.2	86.9	88.0	86.4	86.3	86.8	87.5	87.4
Italy	80.6	81.3	80.3	80.6	80.8	80.2	79.9	80.2	80.7	80.1	80.1	80.1	80.3	80.4
United Kingdom	81.3	79.3	80.0	81.7	81.4	79.8	79.3	79.3	81.6	79.5	79.1	79.3	79.4	79.1
Belgium	94.2	97.7	97.8	98.2	98.4	97.1	97.2	98.2	98.5	97.5	97.6	98.2	98.7	98.5
Denmark	99.0	104.7	103.3	105.3	104.9	102.9	102.4	103.2	105.1	103.0	103.0	103.1	103.5	103.5
Netherlands	113.6	116.4	115.7	116.7	116.7	114.9	115.2	116.3	116.9	115.5	115.6	116.3	116.9	116.7
Spain	78.9	81.8	81.8	82.3	83.1	81.7	81.0	81.3	82.9	81.3	80.9	81.5	81.5	81.8
Sweden	81.2	79.0	78.9	78.0	78.3	79.1	78.5	79.1	78.0	78.6	78.6	79.1	79.7	79.8
Switzerland	115.8	121.3	119.7	123.9	122.7	120.7	117.9	117.7	124.7	117.9	117.8	117.4	118.0	117.3
Real (relative wholesale-price adjusted) against 18 other industrial-country currencies and 22 emerging-market currencies														
United States	96.8	92.5	91.9	88.9	89.9	93.8	93.5	90.5	89.6	92.0	91.9	90.3	89.4	89.4
Japan	121.6	107.6	114.6	114.0	112.5	113.6	115.1	116.8	112.3	115.1	117.5	116.6	116.3	118.7
Canada	107.8	103.4	102.5	100.6	100.6	103.6	103.3	102.2	100.1	103.0	103.6	102.4	100.6	99.4
Australia	98.5	94.7	93.4	90.8	91.3	94.7	95.4	92.0	91.1	95.5	94.6	92.2	89.2	86.1
Germany	104.6	107.9	105.8	108.5	108.1	104.8	104.4	106.0	108.5	105.1	104.8	106.1	107.2	106.4
France	100.2	104.2	102.5	105.0	103.7	101.4	101.6	103.2	104.2	102.0	102.2	103.1	104.4	104.0
Italy	107.8	110.1	107.4	109.7	109.4	107.0	106.3	106.9	109.7	106.6	106.5	106.8	107.3	106.9
United Kingdom	94.1	96.1	99.6	100.7	101.6	99.0	98.4	98.9	101.9	98.9	98.3	99.0	99.5	100.2
Belgium	79.7	84.1	84.3	84.2	84.7	83.9	83.9	84.7	84.5	84.4	84.7	84.5	84.9	85.1
Denmark	106.0	111.4	108.1	112.2	109.9	108.2	106.6	107.9	109.4	108.2	107.9	108.1	107.8	106.0
Netherlands	107.0	109.8	110.0	111.3	110.1	107.6	109.7	112.6	110.6	110.8	111.1	112.5	114.1	113.9
Spain	109.6	116.4	117.4	117.4	119.7	116.7	115.9	117.3	119.0	116.6	116.3	117.7	117.9	118.9
Sweden	105.1	103.6	102.2	102.3	102.4	102.1	101.4	102.6	102.5	101.7	101.3	102.8	103.8	104.2
Switzerland	106.4	114.8	116.0	118.8	118.6	116.0	114.0	115.1	120.1	114.6	114.6	115.2	115.7	115.5
Argentina	50.0	58.8	69.1	76.0	68.5	69.7	69.1	67.7	69.3	68.1	68.7	67.5	66.9	67.0
Brazil	98.3	117.8	90.5	97.7	91.6	90.2	94.8	85.3	91.4	94.2	87.8	86.5	81.5	79.2
Chile	62.3	60.0	65.0	61.4	61.7	66.0	66.6	65.1	61.6	65.9	66.2	65.3	63.8	65.6
Mexico	74.0	69.2	75.3	68.6	71.6	75.3	76.1	76.9	70.5	75.8	75.9	77.2	77.7	78.6
Venezuela	62.0	52.4	51.7	50.3	50.0	52.4	51.9	52.7	50.4	52.0	52.8	53.3	52.0	52.4
Hong Kong	98.6	98.9	106.1	98.4	98.1	108.4	108.7	109.4	96.9	108.3	110.2	110.6	107.4	106.4
Indonesia	55.3	54.4	54.4	51.8	52.5	55.0	55.9	54.1	51.7	55.1	54.6	54.3	53.4	53.1
Korea	92.2	84.9	83.3	81.8	82.5	85.6	84.9	80.3	82.2	83.2	81.6	80.0	79.1	78.6
Malaysia	79.4	75.8	75.6	72.6	73.9	76.6	76.5	75.3	73.3	75.9	76.3	75.4	74.1	76.5
Philippines	95.4	88.5	87.2	82.2	81.2	85.0	90.2	92.7	82.7	91.1	89.9	94.5	93.9	95.4
Singapore	78.1	80.5	83.0	80.6	80.6	82.6	84.2	84.5	80.2	83.9	84.1	84.2	85.1	85.8
Taiwan	100.8	93.8	92.7	91.4	91.1	93.1	93.9	92.6	91.3	93.3	92.6	92.7	92.7	94.3
Thailand	77.1	74.6	79.5	76.1	76.5	79.2	79.8	82.3	76.5	79.5	83.3	82.2	81.3	81.9

* A currency's nominal effective exchange rate is an index of its trade-weighted average value against the currencies of the country's principal trade partners. The real effective exchange rate, which adjusts the nominal index for relative price changes, gauges the effect on the international price competitiveness of the country's manufactures due to currency changes and differential inflation. The relative price changes are based on indices most closely measuring the prices of domestically produced finished manufactured goods, excluding food and energy at the first stage of manufacturing. The weights for the currency indices are derived from 1980 bilateral trade patterns of the corresponding countries.

J.P. Morgan Government Bond Index: total return performance

percent change, end of period from like preceding period

				1990		1991				1992			
	1989	1990	1991	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Jan	Feb	Mar
In local currency terms													
United States	14.0	8.6	14.8	1.0	5.2	1.9	1.4	5.5	5.3	-1.6	-1.4	0.4	-0.6
Japan	-1.5	0.8	13.8	-4.4	8.8	2.1	0.5	6.1	4.4	1.8	0.7	0.2	0.8
Canada	12.8	7.4	21.0	1.3	6.7	5.9	0.3	7.3	6.2	-1.4	-0.5	0.4	-1.4
Australia	13.7	18.8	26.3	4.4	8.3	5.3	3.7	6.5	8.6	-1.1	-2.9	0.8	1.1
Germany	1.0	1.1	11.9	0.4	2.7	4.1	1.9	2.3	3.1	2.4	2.0	0.7	-0.3
France	4.1	7.3	15.9	-1.2	4.7	6.4	2.1	3.4	3.2	1.3	1.3	0.5	-0.5
Italy	12.0	14.6	17.2	2.3	3.1	4.9	3.9	4.0	3.4	3.1	1.8	1.1	0.2
United Kingdom	8.0	9.5	16.8	1.0	7.5	6.7	0.8	7.2	1.3	1.5	2.6	1.4	-2.4
Belgium	2.0	8.8	13.3	-0.3	4.0	4.9	2.1	2.9	2.7	2.2	2.1	0.6	-0.5
Denmark	5.0	10.2	16.1	-0.2	4.0	6.2	2.7	2.9	3.5	1.2	1.7	0.4	-0.9
Netherlands	-0.2	3.3	11.4	0.4	2.8	3.9	2.1	1.9	3.1	2.9	2.1	1.4	-0.6
Spain	9.2	14.8	17.5	2.2	4.6	6.5	4.3	3.8	1.9	3.3	1.9	1.2	0.1
ECU	..	7.4	16.2	0.6	5.1	5.9	2.5	3.8	3.2	1.3	1.5	0.7	-1.0
In dollars													
United States	14.0	8.6	14.8	1.0	5.2	1.9	1.4	5.5	5.3	-1.6	-1.4	0.4	-0.6
Japan	-14.5	7.2	23.4	5.3	11.3	-1.7	2.7	9.9	11.2	-4.4	0.1	-2.6	-2.0
Canada	16.1	7.2	21.5	2.0	6.4	6.0	1.8	8.2	4.0	-4.2	-2.1	-0.2	-1.9
Australia	5.1	16.2	24.3	8.9	1.2	5.6	2.6	11.0	3.3	0.2	-4.1	1.2	3.3
Germany	5.6	14.8	9.8	6.5	8.1	-8.7	-4.2	11.2	13.0	-5.6	-3.8	-1.1	-0.8
France	8.9	22.4	13.4	5.1	8.4	-6.1	-4.2	11.8	12.7	-5.9	-4.2	-1.0	-0.7
Italy	15.5	28.8	15.1	6.4	7.3	-6.2	-2.4	12.4	11.9	-4.4	-3.1	-0.6	-0.7
United Kingdom	-3.7	31.3	12.8	8.2	11.1	-3.6	-6.4	15.7	8.1	-5.7	-1.8	-0.5	-3.5
Belgium	6.7	25.2	12.0	5.5	8.7	-7.3	-4.0	11.8	12.5	-5.5	-3.6	-1.0	-1.0
Denmark	9.1	25.6	13.5	5.6	7.6	-6.4	-3.5	11.9	12.4	-6.3	-4.0	-0.9	-1.5
Netherlands	4.5	17.2	9.5	6.3	8.2	-8.7	-4.1	10.8	12.9	-5.1	-3.6	-0.4	-1.2
Spain	13.1	31.1	16.6	6.6	7.1	-3.4	-2.7	11.6	11.2	-3.9	-3.0	-0.4	-0.6
ECU	..	24.3	12.9	6.6	9.9	-6.6	-4.0	12.3	12.1	-6.0	-3.5	-0.8	-1.7
Global	6.8	11.8	15.5	4.7	3.1	7.0	-0.8	-0.1	8.0	7.8	1.6	5.1	-2.0
Global excluding United States	-2.4	15.6	16.0	6.5	5.7	9.1	-4.3	-2.0	11.4	10.9	2.3	7.4	-2.6

J.P. Morgan Government Bond Index: 10-year constant-maturity yields

*percent per annum, semiannual basis**

				1990		1991				1992			
	1989	1990	1991	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Jan	Feb	Mar
United States	7.91	8.06	6.69	8.80	8.06	8.03	8.23	7.45	6.69	7.52	7.28	7.25	7.52
Japan	5.59	6.65	5.57	7.93	6.65	6.58	6.78	6.07	5.57	5.54	5.57	5.58	5.54
Canada	9.56	10.28	8.25	11.19	10.28	9.52	10.06	9.09	8.25	8.76	8.52	8.35	8.76
Australia	12.93	12.05	9.39	13.62	12.05	11.38	11.16	10.32	9.39	9.85	10.10	10.04	9.85
Germany	7.26	8.99	8.05	9.11	8.99	8.51	8.49	8.38	8.05	8.02	7.90	7.82	8.02
France	9.37	9.97	8.57	10.53	9.97	9.10	9.16	8.87	8.57	8.67	8.44	8.41	8.67
Italy	14.08	14.54	12.88	14.61	14.54	13.68	13.32	12.90	12.88	12.76	12.60	12.48	12.76
United Kingdom	10.20	10.96	9.75	12.19	10.96	10.12	10.49	9.58	9.75	9.87	9.40	9.27	9.87
Belgium	9.42	9.97	8.88	10.53	9.97	9.36	9.35	9.10	8.88	8.87	8.60	8.62	8.87
Denmark	10.25	10.49	8.73	11.01	10.49	9.38	9.28	9.06	8.73	8.58	8.51	8.52	8.58
Netherlands	7.84	9.15	8.56	9.29	9.15	8.73	8.75	8.77	8.56	8.37	8.36	8.17	8.37
Spain	14.12	14.60	11.27	15.11	14.60	12.52	11.94	11.30	11.27	10.91	10.82	10.68	10.91

* For each of the J.P. Morgan Government Bond Index countries, the data are calculated as the semiannual yield of the single most liquid bond component within four months of the stated maturity.

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World Financial Markets

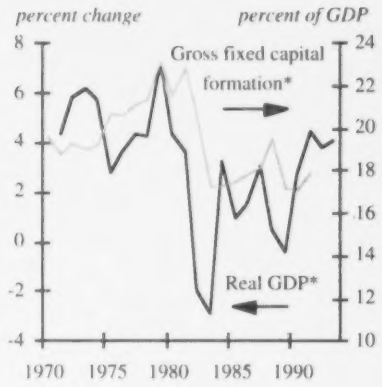
July/August 1992

Growth and investment in Latin America

Latin America's dramatically improving, but uneven, economic record warrants a differentiated appraisal of its prospects for sustained growth.

- Apart from Brazil, the major economies can expect to continue 4% real GDP growth – in the teeth of a sluggish world economy.
- Argentina's investment will need to rise sharply to sustain rapid economic growth; elsewhere, the need is less for increased investment *quantity*, more for world-class investment *quality*.
- The latter is within grasp for most of the region, thanks to domestic structural reforms and trade and capital opening to the wider world; but Brazil lags on these priorities too.
- Investments in much of Latin America still face stabilization risks; in Brazil and Venezuela, fiscal redress conflicts with socioeconomic pressures, and Peru's fiscal position also needs further work.

Latin America: growth and investment



*Major countries excluding Brazil.

Latin America's pension reforms

Barely noticed in the wider world, Chile is in the vanguard of social security reforms in Latin America. These aim to limit fiscal deficits and build private pensions responsibility enhancing long-term economic growth.

- Large private pension funds have sprung up in Chile; they have yielded excellent financial returns and their fast growth is profoundly reshaping Chile's domestic bond and equity markets.
- The funds' commanding size taxes the limits of their investment guidelines; the resulting challenge for positive regulation recurs in pensions privatization moves across Latin America and worldwide.

Global economic outlook

Midsummer malaise – or worse – besets the G-7 economies. In fact, Europe's output recently has been falling, rather than expanding.

- Recession now threatens Europe as a whole, and no G-7 economy will surpass its potential growth rate in the year ahead.
- Falls in underlying inflation will consolidate in the English-speaking countries and Scandinavia, but come very slowly in Germany.
- The Bundesbank is unlikely to ease policy this side of 1993 but, once it does, European interest rates will plunge.
- The dollar's weakness will provide welcome external demand support for the U.S. economy in coming months, but compounds downside risks for Europe's economies and some ERM parities.

Contents

Growth and investment in Latin America, 3
An uneven recovery to date, 5
Investment requirements, 5
Growth and external financing, 9
Growth and domestic saving, 11
Toward stable growth, 13

Latin America's pension reforms, 15
Chile's radical new system, 15
Privatization benefits in Chile, 16
Initiatives elsewhere, 17
Privatization's ongoing challenge, 18

Global economic outlook, 19
The Americas, 20
Europe, 22
Asia/Pacific, 24

Effective exchange rates, 26
J.P. Morgan Government Bond Index, 27

Global economic outlook in summary, 28

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Growth and investment in Latin America

Chart 1

Latin America: real GDP growth

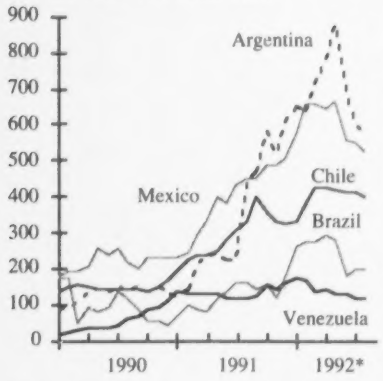
percent from year earlier

*Argentina, Brazil, Chile, Colombia, Peru, Mexico, and Venezuela.

Chart 2

Stock market indices

January 1989=100, dollar basis



* Latest plot: August 7.

Principal author:
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Ten years after the debt crisis first hit, Latin America is again growing rapidly. Despite recessions or slow growth in most of the industrialized world, the region's seven major economies averaged 3.2% growth in 1991. They likely will grow faster this year, with real growth rates as high as 6%-7% in Argentina and Chile (see Chart 1).

The resumption of growth in Latin America is a direct result of stabilization and reform programs that have reduced inflation, improved efficiency, and increased aggregate supply. By 1991, every major country in the region except Brazil had taken steps to replace inward-looking, statist policies with programs to open their industries to competition and reduce the role of government in their economies. In a vote of confidence in the reforms, large-scale capital inflows to the region resumed, helping to drive equity prices to stellar heights in many Latin American markets in 1991 and early 1992 before prices fell back more recently (see Chart 2).

Yet despite all the good news of the last few years, the question of the day is whether Latin America's newfound economic advance can be sustained. The question subdivides: Is the region's investment effort adequate? Can adequate savings be mobilized from foreign and domestic sources to finance it? And, bearing in mind that per capita incomes in Latin America have yet to rebound fully from their 7% average decline in the "lost decade" after the debt crisis, can progress on reform and stabilization continue amid intense socio-political pressures?

The adequacy of Latin America's *physical* investment or savings effort is not yet proven, no matter how cheering the signs that investment is rising in Mexico (and this year again in Chile) or the region's wider success in luring home "flight capital" of its own residents plus other *financial* investment from international markets.

Concerning investment, there are fundamental, and intertwined, issues of *quantity* and *quality*. The quantity of fixed investment in Latin America during the "lost decade" of the 1980s sagged far more severely than did output. Seemingly, fast output growth in the 1990s will require a dramatic investment boost.

This *quantity* inference is correct for some countries, such as Argentina whose gross investment runs barely in double-digits as a percent of GDP. But for most of Latin America, emphasis on investment quantity is less critical than the need for sustained improvement in its *quality*. Studies of the growth process in industrial and developing countries concur on quality's vital role as quantity's handmaiden in promoting fast output and productivity growth. Traditionally in Latin America, bureaucratic suppression and manipulation of market mechanisms worked against high-quality investment. Thus Brazil's investment exceeded 20% of GDP during the lost decade; it

has not paid off in output. The main reason: Brazil has lagged on structural reforms.

Elsewhere in Latin America, by contrast, the past decade's reforms – in external trade and financial liberalization, public sector management, and privatization – have gone far to introduce or rehabilitate market mechanisms as the guiding force for investment. This way, investment quality has a chance to match that of industrial countries. With such high-caliber investment, the amount required to support 5% annual output growth in the seven major countries of Latin America over the next five years could total no more than $200 billion annually in today's prices – just 10%-20% above the depressed actual pace of the past five years.

In Chile and Colombia, there is evidence already that investment is proving every bit as efficient as in the industrialized nations – as it will have to be for Latin America to compete effectively in global markets for the capital of both overseas investors and its own residents. Some day, global capital shortage may be a live, more than rhetorical, concern. Even this year, as the current account deficit of the seven major countries nearly doubles from the $13 billion recorded in 1991, it is not too soon to step up efforts to contain the region's *net* longer-term call on foreign saving in favor of higher domestic saving for investment. This is not to say that Latin America should be less than fully welcoming of foreign capital. Direct investment inflows, after all, bring valuable technology. And openness toward other inward and outward capital flows reinforces domestic confidence, saving, and investment effort – provided government policies are responsible and market-friendly.

Building investment efficiency and savings adequacy takes steadfast reform and stabilization. On reform, there is the challenge to hold public spending to the fullest market tests. In this, privatization is key, both for state production enterprises and also for less obvious public monopolies. Thus, Chile has privatized pensions provision to an extent undreamed in the industrial countries (see article on page 15) – with radical implications for its private capital markets and financial system even as it tackles long-term fiscal imbalance.

Fiscal correction is the main unfinished item on the reform and stabilization agenda across most of Latin America, notably in Brazil, Venezuela and, to some degree, Peru. Only well-conceived fiscal progress – and, in Brazil, a major breakthrough – can simultaneously raise domestic saving, permit predictable financial conditions for private investment, relieve monetary policy's inflation-fighting burden, and yet leave room for alleviation of poverty extremes and of human and public capital deficiencies. Stabilization success will safeguard Latin America's structural reforms. It will thus further domestic goals for economic growth and real incomes. And, in the process, it will rebuild Latin America's self-esteem and the "boundless potential" rating that the region once enjoyed in the global markets and global economy – but this time with substance.

Table 1

Latin America: real GDP growth
annual average percent

	1982-89	1990	1991	1992f
Argentina	-0.4	0.4	5.0	6.5
Brazil	3.1	-4.3	1.2	2.0
Chile	2.8	2.1	6.0	7.0
Colombia	3.4	4.1	2.3	2.0
Mexico	0.4	4.4	3.6	3.0
Peru	-1.0	-4.3	2.9	1.0
Venezuela	0.5	5.7	10.4	3.4
Total of above	1.6	-0.1	3.2	3.1
excluding Brazil	0.5	2.7	4.5	3.8

Chart 3

Latin America: fixed investment
gross fixed capital formation
percent of GDP

*Argentina, Brazil, Chile, Colombia, Peru, Mexico, and Venezuela

Table 2

Latin America: fixed investment
gross, annual average percent of GDP

	1970-82	1983-89	1990	1991
Argentina	20.2	13.7	7.8	10.0
Brazil	24.5	20.1	21.7	20.0
Chile	15.1	14.8	19.5	17.8
Colombia	19.0	19.8	16.3	15.3
Mexico	20.9	19.1	21.9	22.8
Peru	17.6	20.1	14.2	13.3
Venezuela	27.6	19.4	14.2	18.1
Total of above	22.2	18.8	18.8	18.8
excluding Brazil	20.6	17.9	16.9	17.9

An uneven recovery to date

In positive contrast to 1982-89, when its seven largest economies eked out a meager 1.6% average growth rate, much of Latin America is once again growing moderately, even rapidly (see Table 1). Yet on a per capita basis, real GDP has yet to recoup all the losses sustained in the lost decade. And in 1991, Brazil's economy barely grew at all; its government, unable to reach agreement with Congress on fiscal reform, has had to rely on tight monetary policy and high real interest rates to contain triple-digit annual inflation. Elsewhere, 1991 growth outcomes were far from uniform: Argentina, Chile, and Venezuela grew rapidly, but U.S. sluggishness restrained Mexico's growth, and drought plus a tight monetary policy tempered Colombia's. Peru's economy advanced for the first time since 1987, albeit by just 2.9%. Still, excluding Brazil, the major countries grew 4.5% on average last year – a remarkable achievement in the face of recessions or sluggish growth in the industrialized countries that are their major export markets.

Some of Latin America's recent growth, however, has been cyclical. Argentina, Chile, and Peru were in recession as recently as a year and a half ago, and some of their expansion since then has come from bringing excess capacity back on line. That kind of rapid growth does not guarantee that these countries will continue to grow rapidly, nor that they have increased either the level or the growth of their long-term potential.

Increases in an economy's potential GDP require increased investment in plant, equipment, and the labor force, a more efficient utilization of productive capacity, or both. Total fixed investment in several of the major Latin American economies (excluding Brazil) recently has risen from the depths plumbed after the 1980s' debt crisis (see Chart 3 and Table 2). Nevertheless, the investment effort remains low relative to GDP in several of these countries, not only by their own precrisis standards but also by the standards of today's faster-growing countries of Asia. To come closer to the latter's growth performance on a sustainable basis, Latin America will need a larger and more productive fixed investment effort than today's – and not one beholden to state intervention, whose errors of the 1970s ultimately crippled the region's economic well-being in the 1980s.

Investment requirements

Judgment of Latin America's investment needs for the 1990s gains little by recollection of the region's record in the 1970s and early 1980s – except in a cautionary way. It gains more by the fundamental realization that investment input is not, by itself, a sufficient condition for productive output. Rather, the output generated by any given amount of capital depends critically on the technology employed in production – and on the local economic and regulatory environment. Both technology and environment differ markedly in today's Latin America from a decade ago. And the same goes for the global economy in which Latin America now strives to prosper amid fierce competition for markets and capital.

With these points in mind, fast and sustained economic growth of 5% or more annually for the region, in line with widely espoused medium-targets, need not be fanciful. Most countries – though not, remarkably, Brazil – will need to step up the volume of their physical investment significantly to this end. But for some countries – and, in principle, Brazil – potential increases in investment efficiency can keep the required scale of volume increases surprisingly modest.

These conclusions follow from "growth accounting" studies of long-term economic growth worldwide and preliminary recent evidence from Latin America itself. In industrial countries since World War II, about half the growth in real economic output (measured as value added) is traceable to growth of the capital stock and labor force. In developing countries, these two inputs have contributed a higher proportion of growth – on average almost two-thirds (see Chart 4). Fixed investment, specifically, seems more important: Since 1970, developing Asian and Latin American countries investing most in plant, equipment, and structures have grown fastest (see Chart 5).

Even so, the portion of growth in output *not accounted for* by growth in measurable capital and labor inputs – TFP (total factor productivity) growth – is large in developing countries. Indeed, it typically provides nearly half their growth in output *per head*.

As measured, TFP is the catchall for a variety of hard-to-measure, but jointly significant, influences on growth. The most obvious is technological progress; this may be "embodied" in new plant, machinery, and structures, or "disembodied" in new design processes, chemical formulas, and software advances whose adoption may take little or no physical investment. Another growth source is education – that is, investment in "human" capital.* Yet another is economies of scale in production, such as firms may reap by access to new markets abroad – whether through multilateral agreements (which GATT's "Uruguay round" still seeks) or through regional compacts, such as the North American Free Trade Agreement and "Mercosur," a trade liberalization agreement under negotiation between Argentina, Brazil, Paraguay, and Uruguay. Finally, TFP measures the extent to which distortions in economy-wide resource allocation affect productivity. The low level of TFP in Latin America in the past reflected the destructive burden of pervasive price controls, trade restrictions, and subsidies; these prevented efficient combination of labor and capital.

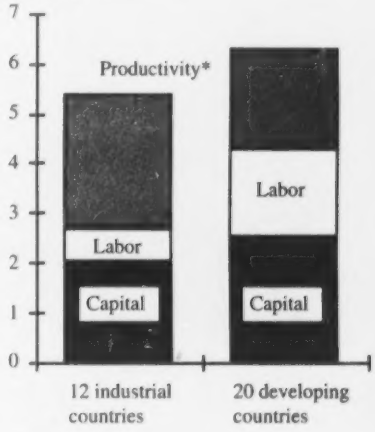
In short, economies that adopt technologically advanced capital and design processes, invest in well-educated work forces, secure access to large markets, face prices that are accurate signals for resource allocation, and are free to deploy factor inputs economically are likely to have high, and faster-growing, productivity.

*Barro (1989) and Mankiw, Romer, and Weil (1990) found that investment in human capital (as measured by secondary school enrollments) was important in addition to the contribution of physical inputs in explaining growth variations across 98 industrialized and developing countries during 1960-85.

Chart 4

Sources of global economic growth*

percentage point contributions to growth of value added



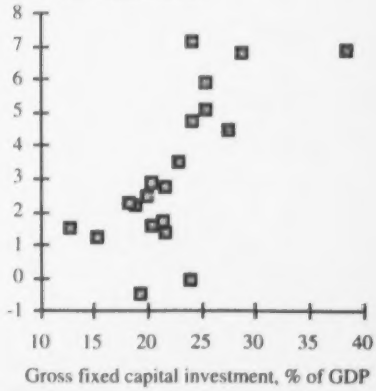
*Total factor productivity contribution, i.e. growth in value added not attributable to labor and capital inputs.

Source: studies surveyed by Chenery, Robinson, and Syrquin (1986) covering various subperiods in the postwar years.

Chart 5

Developing countries: growth and investment*

GDP per capita growth



*1970-91 averages for 20 countries in Asia and Latin America.

Table 3

Latin America: investment required for 5% real GDP growth

calculated investment and growth rates of capital stocks in each country to achieve 3.2% annual growth of real GDP per capita, equivalent to 5% output growth for the region as a whole

	Gross fixed capital formation, cumulative, billions of 1992 dollars				
	Required 1992-96	Actual 1987-91	Required % change from actual	Annual average projected growth Capital stock*	Labor force**
Argentina	125	51	145	3.1	1.0
Brazil	405	445	-9	2.8	1.7
Chile	25	19	32	2.9	1.3
Colombia	40	38	5	2.7	1.5
Mexico	260	224	16	2.7	1.8
Peru	45	37	22	2.6	2.0
Venezuela	60	49	22	2.6	2.1
Total	960	863	11	2.8	1.8

*Growth consistent with 3.2% real per capita GDP growth, assuming – hypothetically – that technology and investment climates are now and henceforward comparable with OECD conditions.
**World Bank (1992) projected population growth rates, 1989-2000.

The calculation of 1992-96 investment requirements

The investment needs derive from the standard accounting relationship between the growth rates of real output (Ydot), total factor productivity (TFPdot), the capital stock (Kdot), and the labor force (Ldot):

$$Ydot = TFPdot + a\,Kdot + (1-a)\,Ldot,$$

where a is the share of capital remuneration in total output and (1-a) the share of labor.

Capital stock data for the seven Latin American economies were taken from Elias (1978), updated through 1991 with gross fixed capital formation and capital consumption data from national and United Nations accounts. (Some capital consumption rates were estimated.) Total factor productivity growth was assumed to account for 57% or 2.85 percentage points of the output growth to occur in the seven Latin American nations during 1992-96, which is equal to the portion so explained in six industrialized nations during 1973-84 examined in Maddison (1987). The share of capital remuneration in income was assumed to be 38.5%, which is approximately the share reported for industrialized countries in several recent studies.

The growth accounting relationship was solved for the required growth rate of capital, and that rate applied to the previous period's capital stock to determine the net fixed capital investment in each period. Estimates of the amount of required gross fixed capital investment were obtained by adding estimated depreciation, which was assumed to occur at the 12.4% of GDP average rate for OECD countries, to the net capital formation figures. Depreciation rates have been rising in Latin America during the past 20 years relative to GDP. In some cases they are at, or above, the OECD average; the rate in Mexico, for example, was 13.8% of GDP in 1987 (more recent data are not available).

Latin America's physical investment in the years ahead is likely to have more in common with today's OECD countries' practice than its own over the past 20 years.* Crucially, the economic environments for physical investment have grown more similar. Recent reforms have swept away many inefficiencies bred by Latin America's formerly closed economies, government controls, and state-owned enterprises in the 1970s and early 1980s. Not enough time has yet elapsed to permit a full-fledged growth accounting of their benefit for TFP. Still, for Chile – Latin America's reform pioneer – and Colombia, the increment to real GDP realized over the ten years to 1990 was higher than in the OECD countries relative to cumulative investment (net of depreciation).**

If the seven largest Latin American countries can henceforth come close to Chile's productivity achievement, they will need gross fixed investment totaling some $960 billion (in 1992 dollars) over the next five years to sustain a 5% trend growth in output (see Table 3). Specifically, this projection assumes that they invest in plant,

*Although many Latin American economies still depend heavily on primary product production, their product mixes are shifting toward those of the OECD economies – and require a commensurate capital stock. For example, service sectors are growing rapidly in Latin America and are going to require much the same technologically sophisticated, computer-oriented, investment that these sectors attract in the OECD.

**Ratios of changes in output to changes in net investment in Chile and Colombia during 1980-90 were 0.38 and 0.37, or slightly above the 0.33 average for the OECD economies in those years.

equipment, and structures offering productivity gains similar to those achieved by industrial nations in 1980-90, and that they follow through on the reforms of the past few years – or, in Brazil's case, introduce and carry them through.

The assumptions underlying the projected $960 billion total investment need for the seven major countries of Latin America are not equally realistic for all. In particular, they likely understate in some degree the requirement for the most important single case. *Brazil* accounted for over half the seven's physical investment outlays over the past five years. And, although the percentage now appears to be slipping, Brazil has kept its gross investment above 20% of GDP. It is far from clear, however, that Brazil has achieved 5% potential output growth: Following fast growth in 1985-86, its actual real GDP advanced only 0.7% annually in 1987-91.

If today, at a stroke, Brazil could adopt OECD-competitive technology plus the wide-ranging reforms of other Latin American countries, it would be in line for 5% potential GDP growth with 9% *less* fixed investment over the next five years than in 1987-91. Instead, Brazil is hardly out of the starting gate on implementing even those structural reforms it has so far proposed or enacted. Consequently, for some protracted period still ahead, Brazil is unlikely to achieve the investment efficiency that others in Latin America have within grasp.

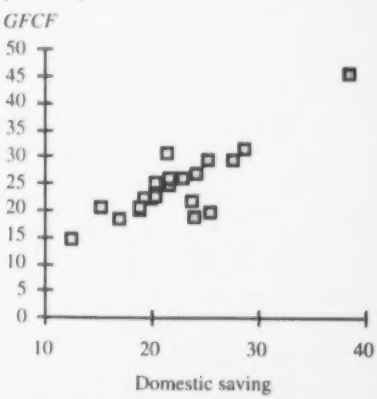
According to Table 3, the other six major countries in the region will need to increase capital formation by an average of one-third over the next five years to achieve 5% trend output growth. There is wide dispersion among the six:

- *Argentina*, most of all, faces a severe challenge to boost investment. It will need a huge 145% increase in gross fixed capital formation in the next five years to meet the potential growth target. This may be too ambitious: Its fixed investment fell to only 8.9% of GDP in 1990 – the lowest such ratio in Latin America – and rose to only 10% last year despite the success of the Menem government in stabilizing the economy and achieving 5% actual real GDP growth.
- *Peru*, too, will need much higher investment than the 13.3% of GDP recorded in 1991 – quite a challenge, in that its investment level has been falling steadily ever since a boomlet under the populist Garcia government wore off in 1988.
- *Venezuela* will need a substantial rise in fixed capital formation above its 1987-91 average to permit rapid growth. Yet private investment declined sharply in 1989-90 after the government introduced a stringent stabilization plan, and will decline this year as firms wait to see whether President Perez' reforms survive the political turmoil that has engulfed the country since February's attempted coup.
- *Mexico*, by contrast, will not need any large rise in physical investment; 16% will suffice following its recent investment boom, which has boosted its investment-GDP ratio, 22.8% in 1991, to the highest among major Latin American economies.

Chart 6

Developing countries: fixed investment and domestic saving*

percent of GDP



*1970-91 averages for 20 developing countries in Asia and Latin America. Investment measured by gross fixed capital formation (GFCF); domestic saving approximated as GFCF plus the current account deficit. The association is known as the Feldstein-Horioka effect after the two researchers who documented it for the industrialized countries in 1980.

- *Chile* too would not need much higher investment effort today, had not government policy to avert economic overheating in 1990 caused investment to fall sharply in 1991. Chile now will need to increase physical investment by 32% to reach the target potential GDP growth. Fixed investment is already on the rise again, however. It should exceed 20% of GDP this year – more than enough to meet the 5% target.
- *Colombia* will require a mere 5% increase in physical investment. Its investment has averaged almost 20% of GDP throughout the past decade; indeed, it now would need to raise investment hardly at all, had not investment dropped sharply last year under inflation-fighting monetary policy.

Growth and external financing

Chile, Colombia, and Mexico appear to be investing enough to secure rapid economic growth over the next few years. The investment increases needed to sustain growth in the rest of Latin America, however, cannot be taken for granted. What can investment-short countries do to assure the capital formation crucial to raising potential and actual GDP growth?

All investment must be financed; accordingly, higher capital formation will require a commensurate increase in saving. Globally, country-by-country variations in physical investment are closely related to variations in domestic saving (see Chart 6).* This fact, as well as the harsh consequences of Latin America's debt crisis ten years ago, counsels that domestic sources should provide by far the lion's share of the needed saving. Already, there has been some disquiet over Mexico's large current account deficit – a probable $17 billion this year. True, capital inflows have flooded into Mexico and most of the region on an impressive scale during the last couple of years; balance of payments data suggest that Latin America received approximately $36 billion in net capital inflows from abroad in 1991, or double the $17 billion inflows of 1990 (see Table 4). Many of the inflows, however, could reverse if investors' hopes are in any way disappointed.

The sources of external finance for Latin America have changed markedly over the past five years (see Table 5 on page 10). During 1987-89, the financial resources that reached Latin America from abroad consisted principally of net equity investment, including debt-equity swaps, and borrowing from international financial institutions and official bilateral creditors (such as export-import banks of the industrialized countries). Commercial banks and other private creditors provided no *net* financing: Discounted debt transactions with banks and repayments to other private creditors more than

Table 4

Latin America: net capital inflows*
billions of dollars per annum

	Average 1987-89	1990	1991
Argentina	1.9	0.9	4.7
Brazil	-02	2.9	1.3
Chile	1.0	3.0	0.9
Colombia	0.3	0.1	-0.6
Mexico	1.4	10.3	21.4
Peru	1.2	1.8	4.0
Venezuela	0.9	-3.7	1.3
Other**	1.5	1.9	2.6
Net of above	8.1	17.3	35.6

*Inferred as the sum of the current account deficit and the net increase in official reserves through transactions of the monetary authorities.

**Bolivia, Costa Rica, Dominican Republic, Ecuador, Jamaica, Panama, Paraguay, Trinidad and Tobago, and Uruguay.

Source: Institute of International Finance.

*Some kinds of capital formation, such as in residential housing or physical investment by small- and mid-sized businesses, new firms, or firms with middling-to-poor credit standings, do not lend themselves easily to foreign investment. Overseas investors find the costs too high to discover, evaluate, and monitor such investments relative to their scale and likely returns; usually, such projects must be financed locally.

offset new credit flows and involuntary financing through the accumulation of interest arrears.

More recently, Latin America's access to the international bond markets has improved dramatically. Venezuela was the first to regain access, in 1988, followed over the next two years by Chile and Mexico. In 1991, they were joined by Argentina and Brazil, and as a group issued over $7.8 billion in bonds overseas. Other forms of borrowing from private nonbank creditors abroad also have increased. At the same time, as investors have gained confidence in Latin America's reforms and macroeconomic policies, net equity investment – portfolio as well as direct investment – have risen sharply. Several Latin American corporations have completed successful equity offerings abroad, helping boost the net inflow of portfolio and direct equity investment into the region in 1991 to $16.8 billion. Finally, Latin America's balance of payments "errors and omissions" show a large, unaccounted-for, inflow of funds, which supports the anecdotal evidence that many of the capital flows into the region represent repatriated flight capital.*

For the future, international capital markets have a constructive role to play in Latin America's growth strategy over and above whatever absolute amount of funds they may contribute. The issue once again: quantity plus quality.

For example, higher foreign direct investment in Latin America can play a uniquely important role in marshaling resources for capital formation. It is often the entry vehicle for new technologies, design processes, and management skills developed abroad. And the old complaint – however questionable – that direct investors were exploitative has lost credible foundation; Latin America's remarkable strides in liberalizing external trade (see Table 6) have substantially eroded the scope for domestic profiteering behind stiff protective walls. Foreign direct investment, moreover, can provide a significant portion of total investment in those countries that manage to attract it: Last year it contributed 18.5% of Argentina's gross fixed capital formation, 10.5% of Chile's, and 8.7% of Mexico's.

Capital markets in most of Latin America remain small relative to GDP. Corporate bond markets, in particular, are poorly developed or nonexistent. In recent years, many Latin American firms have funded themselves principally through short-term local currency or dollar borrowing, including short-sales of government securities. And, with limited choices at home and nearly all cut off from international capital markets, Latin American firms also have tended to finance even long-term investment projects with short-term borrowings. Such firms leave themselves at risk of unanticipated increases in borrowing costs and possible difficulties in rolling over their short-term borrowings at maturity. Firms able to

*While the "errors and omissions" items doubtless capture returning flight capital, they understate investments in Latin America out of residents' overseas funds. Some of these are included in figures on net equity investment and borrowing from nonbank private creditors.

Table 5

Latin America: capital inflows by type
billions of dollars per annum

	Average 1987-89	1990	1991
Equity and direct investment (net)	7.4	9.8	16.8
Borrowing (net)			
International financial institutions	2.4	5.9	0.1
Official bilateral creditors	3.4	3.3	4.0
Commercial banks*	-1.3	3.9	-2.2
Other private creditors	-3.2	2.3	10.4
Resident lending abroad	-3.1	-5.5	0.0
Errors and omissions	1.5	-2.2	6.6
Net of above	8.1	17.3	35.6
equals sum of:			
Current account deficit	8.0	2.2	18.0
Increase in official reserves	0.1	15.1	17.6

*Net new credit flows, interest arrears, and discounted debt transactions.

Source: Institute of International Finance.

Table 6

Latin America: import liberalization
1991 figures: 1991 or more recent date

	Nontariff barriers, % coverage in manufacturing		Tariffs, %		
			Maximum		Average
	1985	1991	1985	1991	1991
Argentina	100	15	38	22	10
Brazil	100	10	205	50	25
Chile	0	0	15	11	11
Colombia	99	50	220	70	12
Mexico	100	2	100	20	12
Peru	100	80	91	25	15
Venezuela	50	5	135	40	8

Table 7

Latin America: investment and saving
percent of GDP in current prices

	Gross fixed investment	Saving*	
		Domestic	Foreign
Argentina			
1983-89	13.7	10.6	3.0
1990	7.8	9.5	-1.7
1991	10.0	7.6	2.4
Brazil			
1983-89	20.1	19.5	0.6
1990	21.7	21.2	0.5
1991	20.0	19.4	0.6
Chile			
1983-89	14.8	9.2	5.6
1990	19.5	17.3	2.2
1991	17.7	17.7	0.0
Colombia			
1983-89	19.8	17.5	2.2
1990	16.3	17.6	-1.3
1991	15.3	21.1	-5.8
Mexico			
1983-89	19.1	19.7	-0.6
1990	21.9	19.5	2.4
1991	22.8	18.2	4.6
Peru			
1983-89	20.1	18.0	2.1
1990	14.2	12.6	1.6
1991	13.3	9.9	3.4
Venezuela			
1983-89	19.4	20.7	-1.3
1990	14.2	31.2	-17.0
1991	18.1	20.1	-2.0
Total, major 7			
1983-89	18.8	18.0	0.8
1990	18.8	19.0	-0.2
1991	18.8	17.1	1.7
Major 7 excluding Brazil			
1983-89	17.9	17.0	0.9
1990	16.9	17.5	-0.6
1991	17.9	15.5	2.5

*Domestic saving: gross fixed investment less foreign saving (definition excludes saving that finances inventory accumulation).

Foreign saving measured by the current account deficit. For nearly all of Latin America, except Colombia, much or all net financing of domestic investment from foreign saving was obtained for several years following the 1982 debt crisis as the counterpart to interest payments arrears or reschedulings that were less than voluntary for some creditors.

gain access to international markets, by contrast, have been able to slash not only their capital costs but also – if well advised and managed – their interest rate, exchange rate, and rollover risks.

Provided Latin America sustains its reforms, it should be able to rely increasingly on equity investment and borrowing from nonbank creditors over the next five years. Still, as in the past, private issuers' access to the international markets will depend on sovereign-risk perceptions. A major step forward has been restored relations with bank creditors, thanks to accords along the lines of the "Brady Plan" for Argentina, Costa Rica, Mexico, Uruguay, and Venezuela covering bank debt with a face value of over $150 billion. Overall, 16 countries in Latin America have cut the face value of their external debt by over $70 billion through debt conversions such as debt-equity swaps, debt buy-backs, and private sector restructurings. Countries that signal enhanced creditworthiness by such deals with banks, and that persevere in reducing inflation, lowering debt ratios, and limiting public sector budgets, should find that their sovereign and corporate issuers are able to continue to raise funds in the international capital markets. Even better, they will gradually be able to lengthen their debt maturities and incur lower country-risk premiums in bond and dividend yields.

Growth and domestic saving

However important foreign investment may be as a catalyst to growth in Latin America, domestic saving constitutes the vast bulk of all resources marshaled for its capital formation. Yet the region's domestic saving effort recently seems to have been slipping (see Table 7). To correct this, Latin American nations seeking to raise their potential GDP growth can take initiatives in at least three areas to make possible greater and more productive investment.

First, they can increase *public saving*, thereby reducing the role of government as a borrower in the economy. During the 1970s and early 1980s, Latin America's large public sector deficits absorbed household and corporate savings and crowded out domestic borrowers. Today, Brazil's public sector deficit is even larger relative to GDP today than a decade ago. Most governments in the region, however, have markedly reduced their deficits (see Table 8 on page 12); indeed, the current revenues of public sectors in some countries – such as Colombia and Mexico – exceed current expenditures and thus add to resources for public investment.

Second, Latin American countries can increase the flow of domestic saving into investment by *social security reform*. The most promising model for reform comes from Chile. Its new system, in which participants invest privately in domestic deposits and securities, has helped reduce long-term fiscal losses and build Chile's capital markets (see article on page 15).

Third, restructuring of *domestic banking systems* – by far the largest source of investment financing in Latin America – will make them more efficient intermediators be-

tween savers and borrowers. Governments traditionally have played a large role in Latin American banking systems – and to poor result in most.* Efficient mechanisms of intermediation can take decades to develop – as they did in industrial nations.

Nonetheless, several Latin American countries have made considerable progress in recent years in privatizing and deregulating their banking systems. In 1990 Mexico amended its Constitution to permit Mexican individuals and companies to own controlling interests in its commercial banks, and created a committee to oversee the sale of nationalized banks to private investors. Since then, all 18 commercial banks have been privatized. Peru also intends to privatize commercial banks nationalized during the 1980s, which today account for about half of total banking system assets.

Fiscal reforms, meanwhile, have freed several governments from reliance on commercial-bank financing of budget deficits. This has allowed them to relax credit controls and cut reserve requirements on banks. In 1988, for instance, Mexico introduced a new "liquidity coefficient" that lowered the percentage of bank funds that had to be invested in government securities to 30%. (The deposit base subject to the liquidity coefficient was reduced further in September 1991.)

In addition, deposit-rate ceilings have been eliminated in most Latin American countries. Though inflation surprises can still leave depositors worse off, their realized inflation-adjusted rates of return now are more often positive (see Table 9). Perhaps more importantly – for both lenders and borrowers – real interest rates now fluctuate much less wildly than in former years in most of the region – though not in Brazil or Peru.

Beyond the liberalizing steps taken so far, scope exists for further reduction of government involvement in the Latin America's financial systems. Argentina's 31 state-owned banks account for about 45% of total loans in its banking system, and Brazil's for almost half that country's bank assets. Neither plans to privatize its state-owned banks. And though Venezuela has begun to privatize three of the smaller eight state-owned banks (with a 16% share of bank assets), it has no plans to sell its largest official bank (holding two-thirds of

*Governments in several countries, including Mexico and Peru, nationalized all or large parts of their banking systems during the 1980s. And in those countries in which the banking system was not nationalized, state-owned banks and specialized official financial institutions such as mortgage banks or development banks have had a large share of domestic credit markets. Governments have used official banks and state-owned specialized financial institutions to control credit allocation. Official financial firms have often received budgetary transfers and loans from central banks, and have made loans to favored classes of borrowers, such as farmers, exporters, and state-owned enterprises – often at concessionary rates. Governments in Latin America have also been heavily involved in controlling the allocation of credit at private commercial banks, requiring commercial banks to invest a substantial portion of their deposits in government obligations to help finance government deficits, and requiring banks to lend to priority borrowers such as small businesses, agricultural producers, and buyers of low-cost housing.

Table 8

Latin America: fiscal balances
percent of GDP

	1982-84	1985-90	1991	1992
Public sector				
Argentina	-12.0	-9.5	-3.3	-1.8
Brazil	-21.3	-41.7	-29.6	-36.0
Chile	-4.1	0.2	1.0	1.6
Colombia	-6.7	-2.3	-0.3	0.0
Mexico	-8.6	-11.9	-3.5	-1.3
Peru	-8.4	-6.7	-3.0	-4.1
Venezuela	-0.5	-4.8	1.1	1.0
Total of above	-13.5	-22.1	-13.5	-15.2
excluding Brazil	-8.2	-9.0	-2.5	-1.2
*Primary balances**				
Argentina	-6.1	0.1	2.1	2.4
Brazil	-3.5	0.6	4.6	1.0
Chile	-0.7	4.2	6.0	3.0
Mexico	4.5	5.1	7.9	6.0
Venezuela	3.3	-0.5	6.0	5.0

* Excluding interest payments.

Table 9

Latin America: realized real interest rates on short-term bank deposits
monthly data, percent per annum

	1982-1986	Jan 1987-May 1991	Jun 1991-May 1992*
Argentina			
Mean	-3.5	-13.5	-7.3
Range**	-139/132	-80/53	-10/-4
Brazil			
Mean	12.0	10.6	78.7
Range**	-4/73	-94/114	-22/179
Chile			
Mean	6.2	5.1	5.6
Range**	-8/21	-6/16	-4/15
Colombia			
Mean	6.8	0.4	0.3
Range**	0/14	-6/7	-6/6
Mexico			
Mean	-13.4	5.7	-0.9
Range**	-25/-2	-18/29	-4/3
Peru			
Mean	-23.4	-47.7	42.4
Range**	-37/-10	-101/6	8/77
Venezuela			
Mean	0.2	-15.5	-0.5
Range**	-8/8	-34/3	-2/3

*Jan 1992: Colombia, Peru. Jun 1992: Chile.
**Range from 1 sample-period standard deviation below mean to 1 deviation above.

Calculation of realized real interest rates

Nominal interest rates on bank deposits (of various maturities from one to four months) were adjusted for annualized consumer price inflation over the three months *following* the month of deposit.

Table 10

Latin America: inflation
consumer prices, December-December percent per annum

	1985-89	1990	1991	1992f
Argentina	474	1344	84	20
Brazil	465	1585	475	600
Chile	20	27	19	16
Colombia	24	32	27	26
Mexico	74	30	19	12
Peru	443	7649	139	50
Venezuela	33	37	31	36
Total of above	233	521	148	144
excluding Brazil	133	216	41	20

the public sector's financial assets). In addition, few countries in the region have plans to privatize state-owned development banks, many of which are traditionally responsibility to provide long-term finance for politically important projects.

Further scope exists for modernizing and increasing competition in domestic banking systems by allowing entry by foreign banks. Few Latin American countries today provide national treatment to foreign banks (Argentina being a notable exception) and some, such as Brazil, ban the entry of new foreign banks altogether. For its part, Mexico, which has long closed its doors to foreign banks, has agreed in the context of the NAFTA negotiations to permit the entry of U.S. and Canadian financial firms after a long phase-in period – but only through the capital-inefficient organizational form of subsidiaries.

Toward stable growth

From the outset, Latin America's policymakers have been acutely aware that macroeconomic stability and reform are crucial to reviving investment. Stability is important in part because firms have a strong incentive to wait before committing to largely irreversible physical investment: The costs of waiting a year to see whether a stabilization program succeeds before investing are low compared to potential losses if the program fails. Besides, several failed economic programs in the region in the 1980s have demonstrated that investment cannot be counted upon to materialize unless governments follow through with reforms giving correct incentives for capital formation.

The external factors that destabilized Latin America in the early 1980s – an abrupt cessation of capital inflows and skyrocketing international interest rates – represent less of a threat today. Certainly some countries in the region – notably Mexico but also Argentina and Peru – are heavily dependent on short-term capital inflows vulnerable to quick reversal in the event of a change in investor sentiment. International reserves, however, are high and rising in those countries, giving them considerable leeway to avoid precipitous currency declines.

Perhaps more importantly, capital is flowing into a very different environment in Latin America today than in the early 1980s, when the region last experienced large inflows. In most countries, firms now have more flexibility in deciding where and how to produce, have better access to foreign markets and inputs, and face realistic prices. In short, funds are being put to better use than in the past. And although one cannot rule out a rise in short-term rates that increases the cost of servicing floating-rate debt, dollar interest rates are at their lowest in almost 30 years, with no increase in sight.

The threats to perseverance in Latin America today are mainly domestic. Just as fiscal deficit reductions helped curb inflation (see Table 10) and freed resources for uses such as debt reduction, lack of further progress in fiscal reform could jeopardize future stability and growth. While the public sectors in Chile, Mexico, and Colombia are in balance or surplus, and Argentina is making rapid progress in elimi-

nating its deficit, fiscal progress in the other major countries in the region has virtually halted. In Brazil, the Collor administration has submitted an ambitious fiscal reform package to Congress that would reduce the 36%-of-GDP public sector deficit; passage is highly uncertain. In Peru, the Fujimori government reduced the public sector borrowing requirement to 3.5% of GDP last year, from 6.1% in 1989, but is having trouble raising revenue for further reductions. In Venezuela, meanwhile, demands for increased social spending since the February 5 coup attempt will turn a small public sector surplus into a deficit as large as 4% of GDP this year.

Over the next few years, Latin American governments will find their ability to cut aggregate spending constrained by pent-up demands for investment and spending on social services. Several will need to increase capital spending on infrastructure. Neglected during the 1980s in most Latin American countries, infrastructure has deteriorated so badly in some, such as Peru and Venezuela, that it arguably now constitutes a bottleneck to future growth.*

*Public investment in infrastructure need not be wasteful and inefficient. A study by David Aschauer (1989) found that labor productivity growth in the G-7 countries was strongly related to public capital expenditures during 1973-85. An IMF staff study by Mario Blejer and Mohsin Kahn (1984) found that private investment in 24 developing countries was positively related to trend public investment – taken as a measure of investment in infrastructure – but not deviations from the trend, suggesting that investment in infrastructure is a long-run complement to private investment.

The February coup attempt in Venezuela, meanwhile, has served a harsh reminder that fiscal policy must do its part to build a constituency for growth. Although coup participants seem to have had quite narrow grievances, they set off a public outcry against a political and economic system that has failed to deliver material increases in living standards or adequate social services for large segments of the population – despite rapid overall output growth. Increased public spending on roads, schools, hospitals, and housing for those in extreme poverty can all build support for reforms and ultimately enhance growth; but only if they do not jeopardize fiscal discipline.

Altogether, in most countries of Latin America, the fiscal focus will need to be on generating more revenue and improving the composition of government expenditures, rather than spending cuts. Continued privatization of loss-making state enterprises, resistance to general public sector wage hikes, and sustained efforts to broaden tax bases will help raise public saving. The saving can then be deployed toward the alleviation of extreme poverty and investment in infrastructure and human capital – without undoing stabilization gains against inflation or crowding out the private investment critical to sustained growth.

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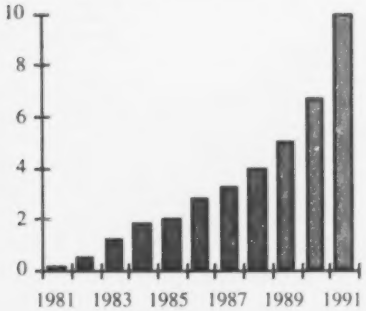
Latin America's pension reforms

Chart 1

Chile: private pension fund assets

billions of dollars



Latin America's economic reforms address both demand- and supply-side failings. The demand side tackles fiscal deficits and inflationary pressures. Supply-side reforms aim to eliminate policy distortions deterring private investment.

Both sides are being addressed by proposed or already-implemented restructurings of Latin America's social security systems. Well-conceived privatization – pioneered by Chile in 1981 in what now serves as a model for the region – can simultaneously reduce fiscal deficits, build and deepen domestic capital markets, and ultimately lead to more ample living standards for both the working population and retirees. But privatized funds present their own challenges and risks respecting investment guidelines, regulation – and sheer size.

Chile's radical new system

In 1981, Chile scrapped its publicly managed, "pay-as-you-go," social security system in favor of mandatory, privately funded and managed, pension programs. The spur came from the preexisting system's fiscal losses – 2% of GDP in 1980 – and, given Chile's demographic profile, the much larger future losses then looming.

Under Chile's new social system, employees pay at least 10% of their monthly salary to one of fourteen registered AFPs (Administracion de Fondos de Pensiones). The AFPs are nonbank financial institutions established for the sole purpose of managing pension investment and administration. Contributors are free to choose and transfer among the various AFPs up to four times yearly. Employees also pay a set percentage of their wages to the AFPs for health, disability, and life insurance (purchased by the AFPs from private insurance firms). Employers pay no social security taxes, except for a small disability levy.

The government tightly regulates the AFPs, for fear of the kind of problems that plagued Chile's banking system in the early 1980s. Initially, the AFPs could invest only in government bonds, bank deposits, and mortgage securities. Since the mid-1980s, however, the AFPs have been able to invest, subject to guidelines, in domestic corporate bonds and equities.* More recently the government has allowed AFPs to invest in *external* fixed-income instruments, although these investments cannot exceed 1.5% of their total assets.

Since their inception, from 1981 through last year, the AFPs have generated high *real* rates of return averaging 15% on their investments. Thanks to these high returns, their large premium inflows, and their presently low pension payment outflows, the funds managed by the AFPs have expanded dramatically (see Chart 1) – from $200 million in 1981 to $10 billion

*AFPs currently can invest up to a ceiling of 30% of their total assets in equities, but only in a small number of approved issues – and with no more than 1% of their funds in a single issue to a maximum of 7% of any individual firm.

Principal author:
Marilyn Skiles, J.P. Morgan, New York

in 1991, or from less than 1% of Chile's GDP in 1981 to 33% last year.

Privatization benefits in Chile

Pensions privatization has had multiple beneficial effects on the Chilean economy. Over time, the new system will curb the central government's social security expenditures.* Yet there is little or no immediate fiscal gain because the government continues to support existing retirees and older workers unable to participate in the AFPs. Moreover, the government retains a *contingent* fiscal obligation through its guarantee of minimum pensions; the AFPs' high investment returns to date, however, make it likely that the funds' future pension payments will exceed the guaranteed minimum. In that case, privatization will have substantially reduced, or even eliminated, the government's future fiscal losses on pension provision.

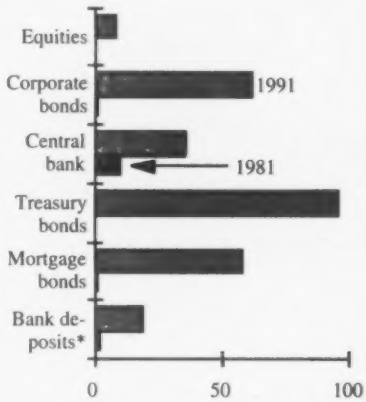
Equally important, the private social security system has been central to the growth of Chile's *domestic capital markets* – now the most developed in Latin America. Contributions to the AFPs amount to some 4% of GDP annually. Because of their large size and the limited amount of foreign investment they are allowed to undertake, the AFPs have emerged as a major domestic source of long-term finance. Thus they have strongly influenced the growth and development of the government bond market, the corporate bond market, and the equity market. In the early 1980s, for example, AFP participation was critical for Chile's *domestic government bond market*. In turn, this helped mitigate inflationary fallout from Chile's acclaimed debt-to-equity conversion program.**

As the AFPs came to dominate the government bond market – in 1991 they held nearly 100% of the entire stock of Treasury bonds (see Chart 2) – they became increasingly key participants in the *domestic corporate bond market*. Their holdings of domestic corporate bonds rose from less than 10% of the stock of such bonds in 1985 to more than 60% in 1991. Largely because of growing investment by the AFPs, financing availability through the corporate bond market has mushroomed over the past few years; bond placements doubled in real value in 1991 alone, when the number of new issues rose from 19 to 27. The market's heightened liquidity gives Chilean firms access to large-scale, long-term, domestic bond financing; in fact, some firms have been able to issue bonds with maturities as long as 25 years.

Investments by the AFPs in the *domestic equity market* also have risen dramatically in the past few years. From 10% of their total investments in 1989, equity holdings climbed to nearly 25% in 1991 (see Chart 3). In contrast to their commanding presence in the corporate bond market, however, the

Chart 2

Chilean AFPs: domestic market concentration

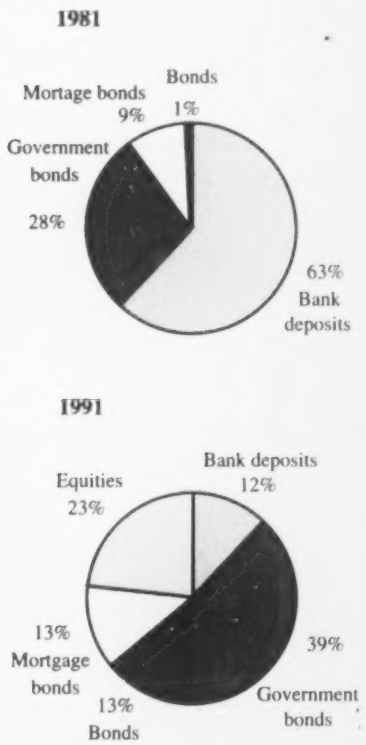


*All workers under 45 years old shifted to the new system when launched; those aged 45-65 had the option to shift; those over 65 stayed with the old system.

**The program extinguished foreign debt to a face value of $11 billion – the largest sum settled by equity conversion for any country in Latin America.

Chart 3

Chilean AFPs: portfolio distribution
percent of total investments



AFPs do not dominate Chile's equity markets – mainly because of the entrance of foreign equity funds, some of which invest exclusively in the Chilean market. Nonetheless, the AFPs' holdings do help stabilize the equity market. The reason: the funds have a long time horizon and orient their holdings for long-term growth rather than short-term speculative gains.

Initiatives elsewhere

To date, *Mexico* is the one country in Latin America, besides Chile, that has completed a reform of its social security system. The new Mexican system differs substantially from Chile's, in particular because it supplements, rather than replaces, its existing system. Under Mexico's former system, employers contributed 7.5% of their wage bills to the social security institute (IMSS) and another 5% to the housing fund (Infonavit). In the new system, which began in May 1992, employers still will pay 7.5% of wages into the existing IMSS. They further will pay 2% into individual Retirement Savings Accounts (SARs). And the 5% previously paid directly to the housing fund will instead pass indirectly through the SARs and with their allocation under the SARs' management.

For now, the Bank of Mexico is managing the individual accounts. In 1993 employees will be free to select their own managers. Unlike in Chile, where the AFPs are rigidly separated from the banks, in Mexico both banks and brokerages will be eligible to manage SARs.

Contributions to the individual retirement funds in Mexico will be considerably less than in Chile: 2% of wages in Mexico, against a *minimum* of 10% in Chile. Still, Mexican officials estimate that the funds will add nearly $1 billion in liquidity to the domestic banking system in their first year of operation, with greater additions thereafter. Moreover, the financing passed on to the housing fund (and the fund's planned comprehensive reform next year to reduce current losses) should substantially increase the availability of mortgage financing.

Argentina's government recently submitted legislation to Congress to reform its traditionally loss-ridden social security system. The proposals would have workers under the age of 45 convert automatically to a self-financing system similar to Chile's. Workers over the age of 45 could choose to remain with the existing system or convert to the new. To finance payments for retirees and older workers staying in the current system, the Argentine government plans to tap revenues from the sale of the state-owned oil company and increase the share of general tax revenues that goes to the current social security system.

Congressional approval of the reform would accelerate Argentina's fiscal adjustment, by eliminating the fiscal losses now generated by social security and curtailing what in recent years has been a fast-rising share of general revenues going to provincial governments.

Elsewhere, social security reform is under discussion in *Brazil, Colombia, Bolivia, Peru, Ecuador, and Uruguay*. In all likelihood, they

will choose new pension systems that borrow at least some features of the Chilean system.

Privatization's ongoing challenge

The success of Chile's AFPs has led to a new problem: Their funds are outgrowing the domestic marketplace (see Chart 3). The government's current strategy is to let them purchase more in the way of foreign issues and widen their allowable range of domestic assets. It remains to be seen if this strategy will suffice in the face of the funds' rapid growth and their already overwhelming domestic financial market presence; or whether the funds will permanently escape political direction – an ever-present danger in many countries, but one that so far has not tarnished Chile's funds.

Other Latin American countries face quite different problems. First, they must correct underlying fiscal imbalances. Without fiscal adjustment, they will not achieve the kind of relatively stable macroeconomic setting prerequisite to a viable pensions-funding system. Moreover, a private pension system may entail abolition of previously earmarked payroll taxes. In that case, general government revenues must finance social security benefits for current retirees. Thus only Latin American countries that have improved their fiscal balances, such as Mexico and Argentina, are well placed to adopt private or semiprivate social security systems.

The second problem, equally serious, is that countries opting for private pensions need adequate regulatory expertise. The success of Chile's AFPs owes much to their close, well conceived, regulation by government. But not all LDC governments possess such expertise, and it surely will take time to develop. Yet, in its absence, it is foolhardy to suppose that private fund managers will be always both competent and prudent. After all, industrial countries with much deeper experience in financial market oversight grapple ceaselessly with the safety and soundness issues of private pension provision. The challenge is amply demonstrated by last year's revelations of spectacular abuses and shortcomings in the United Kingdom, or the problems 20 years ago that spawned today's vast edifice of U.S. "ERISA" regulation.

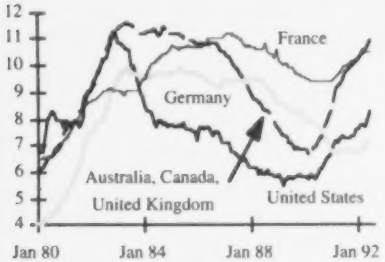
Yet neither industrial nor developing countries can afford to overlook the key advantages of shifting – whether progressively or by quantum leap – the burden of pension funding from public to private shoulders. The advantages stand out in Chile's experience: the containment of public expenditure commitments; the lessening of public disincentive to private thrift; and the empowerment of individuals – on their own or through private financial intermediaries – to invest for maximum and prudent long-term economic return.

The shift, however, is not easy politically. A number of European countries are edging this way – albeit more timidly than the Latin Americans. None has yet been able to match the ambitions – and rewards – of Chile's venture.

Global economic outlook

Industrial countries: unemployment

percent of labor force



Midsummer malaise – or worse – has overtaken the G-7 economies. All are underperforming official hopes for output and jobs in 1992. In fact, activity in Europe recently has been falling, rather than expanding.

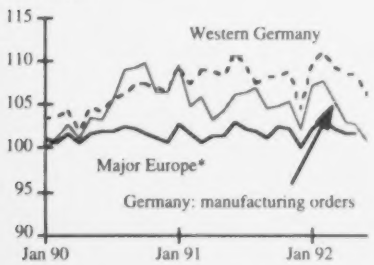
- None of the G-7 economies will surpass its potential growth rate in the year ahead, and Europe teeters on the edge of recession.
- Shortfalls of actual output levels below potential will either widen into 1993 or fail to narrow materially.
- Recession or slow growth has bred steep increases in unemployment in much of the industrial world, in some cases to levels reminiscent of the early 1980s. Scant relief looms anywhere into 1993.

The reductions in *underlying* inflation scored nearly everywhere in the 1990s will consolidate this year and next – notably in the United States, Canada, Australia, the United Kingdom, and Scandinavia.

- In Germany, by contrast, wage rigidity (and this year's high settlements) will make underlying inflation reduction painfully slow.
- The Bundesbank, frustrated also by high money growth, is unlikely to ease policy this side of 1993 despite deepening economic stagnation.

Europe: industrial production

1989=100



*Germany, France, Italy, United Kingdom, Spain, and the Netherlands.

Policymakers sense limits to monetary easing to aid economic revival.

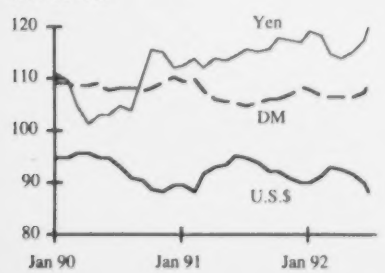
- Within Europe and the ERM, the Bundesbank makes the limits clear this year; but once it eases in 1993, Europe's interest rates will plunge.
- With U.S. bond markets now more cognizant of the low-growth, low-inflation, U.S. outlook, it will take unexpected economic weakness to nudge the Federal Reserve into further rate cuts to spur credit demand.

Expediency rules fiscal policy in most countries, though a few – Canada, Italy, and Spain – seek to limit deficit hikes caused by low GDP growth.

- Except in Canada, fiscal postures have wound up neutral or expansionary for aggregate demand across the industrial world this year.
- Japan will soon step up its fiscal stimulus efforts; other countries will have trouble carrying through their plans for restraint next year.
- Higher fiscal demands may not raise *net* demands on credit markets.

Real effective exchange rates

1980-82=100



The dollar's weakness supports the U.S. economy by adding to U.S. producers' competitive edge in global markets. And, despite yen strength, Japan's recovery in the year ahead also will gain from rising net exports.

- This leaves Europe as the main loser this year and next on the trade front – a factor that amplifies the risks for some ERM parities.

Russia cannot achieve fiscal and monetary control without credit, interest rate, and exchange policy coordination in the ruble zone.

- Under pressure, or of their own accord, some republics will leave the zone – the Baltics and, probably, the Ukraine and Azerbaijan. Hard-currency clearing demands will further disrupt interrepublic trade.

The Americas

United States. "Triple-dip" exaggerates the likely profile of U.S. real GDP since 1990's recession onset, but well conveys the politically potent profile of joblessness since that time, for today, and for several quarters to come.

- Until job gains strengthen durably and substantially, there is less chance of Federal Reserve tightening than of further easing.
- Feeble consumer fundamentals still point to real GDP growth rates that fail to exceed 3% (annualized) any time this year or next – and that leave the unemployment rate distinctly above 7% throughout.
- Even in the improbable event that real GDP growth jumps to the 6% pace typical of the *first year* (only) of recent U.S. cyclical recoveries, "Okun's Law" (see chart, below right) does not warn of dire inflation consequence: 6% growth would have to continue for *two years* to get the unemployment rate down to the 5.5% threshold above which inflation tends to fall, not rise.
- Inflation pressures, whether from labor costs or a depreciating dollar, are not a credible deterrent to further bond yield declines. Nor is the risk that high – even increasing – federal credit demands will outweigh the now established credit-slimming zeal of the private sector.

Canada cannot escape spillover from U.S. economic malaise, given the importance of bilateral exports. Indeed, despite fairly strong 1992Q1 real GDP growth, Canada's unemployment rate – now 11.6% – still is rising fast and, apart from housing, domestic demand indicators are weak.

- Having already muffled any inflation boost from the currency's decline, sluggish demand opens the way to further bond yield declines.

Latin America's real GDP growth will continue to survive North American sluggishness surprisingly well (see article on page 3).

- The region benefits by high stock prices and low competing interest rates to the North, which bolster Latin America's relative attractions.
- The new NAFTA agreement is a boon for Mexico, but faces high ratification hurdles in Canada and the United States.

United States: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1992				1993	Q4/Q4 change	
	1992f	1993f	Q1	Q2f	Q3f	Q4f	Q1f	1992f	1993f
Real GDP	1.8	2.8	2.9	1.4	2.0	3.0	3.0	2.3	3.0
Private consumption	2.0	2.5	5.1	-0.3	1.9	2.4	2.8	2.2	2.9
Business fixed investment	1.9	5.2	3.0	13.5	1.6	3.5	4.2	5.3	6.1
Residential construction	11.5	6.0	20.1	8.7	1.0	9.1	5.7	9.5	5.7
Inventories*	0.3	0.5	-1.7	1.1	0.8	0.8	0.5	0.2	0.2
Net exports*	-0.2	-0.1	-0.1	-1.2	0.0	-0.0	-0.1	-0.4	-0.1
Consumer prices	3.0	2.7	2.8	3.4	2.8	3.0	2.5	3.0	2.6
Civilian unemployment rate (%)	7.5	7.6	7.2	7.5	7.7	7.7	7.7		
Trade balance FAS/CVB ($ billion)	-89	-107	-59	-93	-101	-103	-105		
Current account ($ billion)	-40	-52	-21	-41	-48	-51	-53		

* Percentage-point contributions to real GDP growth.

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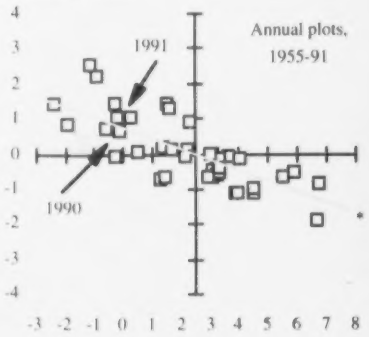
U.S. real GDP and unemployment

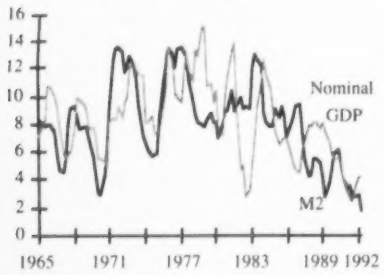
change in unemployment rate from Q4 to Q4, percentage points



* The line represents "Okun's Law": the change in the unemployment rate is about 1/3 of the difference between actual GDP growth and the economy's (currently) 2.5% potential growth rate.

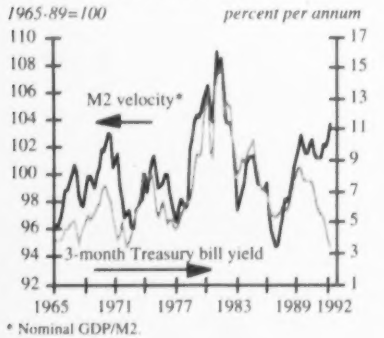
U.S. M2 and nominal GDP

percent change from year earlier



U.S. M2 growth and velocity

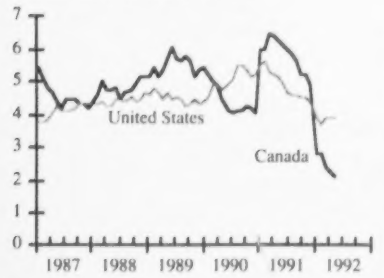
1965-89=100 *percent per annum*



* Nominal GDP/M2.

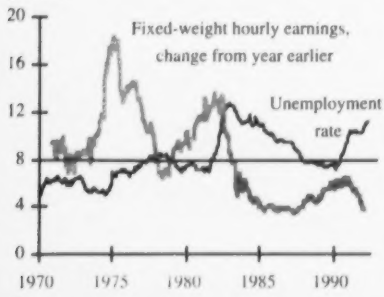
Canada-U.S. core CPI inflation

percent change from year earlier



Canada: earnings and unemployment

percent



U.S. money supply ambiguity

Anemic U.S. economic recovery to date has left the Federal Reserve wide open to the charge that its monetary easings have been chronically "too little, too late." With hindsight, they probably have been – judging from below-target growth of M2 money supply since 1990, not to mention current inflation and activity indicators.

Yet the Fed and – as importantly – the bond markets have not entirely lacked rationale for caution in response to U.S. monetary trends. M1, albeit growing less explosively in recent months, is up nearly 15% annualized since late-1991. Perhaps this can be dismissed as the natural adjunct of sharply lower short-term interest rates, which now provide slim return on liquid balances.

More disconcerting is the behavior of M2 velocity. For better than two decades up through 1989, this displayed a predictability relative to both ultimate goals (such as nominal GDP) and proximate instruments (short-term interest rates) that was lacking in other monetary aggregates. M2 came to be a useful signal to both the Fed and the markets.

Since 1989-90, however, M2 velocity has clung well above its historical average, indeed has recently risen smartly, instead of following short-term interest rates lower. Thus nominal GDP growth has not collapsed as M2 and interest rates would previously have suggested. The apparent explanation: a shift from long-term savings held in CDs (and included in M2) into mutual funds and other securities not so included.

Still, nominal GDP growth has run below 5% over the past four quarters – extending its trend decline since the late 1980s. The trend is unlikely to shift markedly higher while borrowers stay cautious and major slack persists in product and labor markets. Accordingly, anomalously high M2 velocity need not debar lower interest rates across the maturity spectrum.

Canadian inflation: durably below the U.S. rate

Canada now enjoys the lowest inflation among the G-7 countries. Even after the one-time direct effects of currency weakness, June consumer prices were just 1.1% above the year-earlier level (1.9% excluding food and energy). The first-quarter GDP deflator – confined to domestic prices – was up a scant 0.7%. Earlier, in the February 1991 budget, Canada had set official inflation targets. At the time, 3% core CPI inflation by end-1992, and 2% inflation by end-1995, looked unrealistic. In fact, Canada is ahead of schedule. Moreover, even with renewed economic growth and possible further currency weakening, Canadian inflation should stay below the U.S. pace for the foreseeable future.

Canada's labor costs continue to moderate. Hourly earnings increases fell from 6 1/4% (on year-earlier) at the start of 1991 to under 4% recently. They should fall further through the mid-1990s, for the unemployment rate is apt to hold above 10% through at least end-1994. Commodity prices, mortgage rates, housing prices, and factory operating rates also should help keep CPI pressures low.

Long-term bond yields in Canada nevertheless remain about 100 basis points higher than U.S. yields. Seemingly, the approach of national elections (required some time in 1993) makes investors fearful that Canada's taut monetary and fiscal policy stance will not continue indefinitely – such that its 1% adverse inflation differential of the 1980s against the United States could re-emerge. The fear seems overdone: Even if Canada's macropolicy turns stimulative or there is some flight from the currency, the slow-growing global economy means there is little risk of a private-sector boom developing in Canada, let alone one of such intensity as would bring the unemployment rate below the 8% threshold consistent with steady or declining inflation.

Europe

Germany, at least in the old Federal Republic, is unlikely to see significant economic growth either this year or next. Yet because the Bundesbank finds both inflation and money growth unacceptably high, it will not move before 1993 to counter Germany's economic stagnation.

- Dwindling domestic and foreign orders for German manufacturing argue that the 1992Q1 leap in real GNP was an aberration. Nor, beyond a modest lift in this second half of 1992 following expiration of 1991 tax surcharges, is fiscal stimulus a viable offset to the toll of past excess and continuing high interest rates.
- Tax-adjusted core CPI inflation still runs about 3.8%, year-on-year, and would be closer to 5% were it not for the dollar's weakness. The latter will not deliver much enduring inflation benefit, but does deprive Germany – and Europe generally – of external demand stimulus.

Recovery in the rest of Western Europe is barely alive under Germany's high interest rates. Even Spain's once-resilient economy is fading fast, and Italy's will be crippled if the government's fiscal plans take full effect.

- Budget deficits are climbing: The U.K. public sector financial balance has deteriorated by over 5% of GDP in the past three years, for example, and Sweden's by 8%. Though Italy and Spain have recently begun trying to turn the tide, Maastricht's fiscal mandates for early EMU look increasingly beyond reach outside the ERM core.
- Though inflation *rate* convergence continues to gain from pervasive low economic growth, it is painfully slow to redress *cumulative* labor cost discrepancies built up since the last ERM realignment in 1987.
- Devaluation risks must be seen as rising outside the ERM core; the demands of fiscal prudence and stubbornly high real interest rates leave governments no other way to buttress economic recovery.

Central Europe looks fated to hesitant recovery at best – even into 1993.

- Following initial market reforms, restructurings, and privatizations, recession and high unemployment are breeding adjustment fatigue.

Europe: real GDP forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

	1992f	1993f	1992 Q1	1992 Q2f	1992 Q3f	1992 Q4f	1993 Q1f	Q4/Q4 change 1992f	Q4/Q4 change 1993f
Major 4	0.8*	0.9*	3.4	-1.1	0.6	1.0	0.8	1.0	1.2
% change from year earlier			1.0	0.7	0.6	1.0	0.7		
Western Germany (GNP)	0.5	0.5	7.4	-5.6	1.6	1.6	0.8	1.2	-0.4
% change from year earlier			0.8	-0.4	0.4	1.2	-0.4		
France	2.2	1.5	4.0	1.2	1.2	1.2	1.2	1.9	2.0
% change from year earlier			2.7	2.5	1.7	1.9	1.2		
Italy	1.2	0.4	2.4	1.2	-2.0	-0.4	0.8	0.3	1.2
% change from year earlier			2.0	1.6	0.8	0.3	-0.4		
United Kingdom	-0.7	1.1	-1.6	-0.4	0.4	1.2	1.6	-0.1	1.4
% change from year earlier			-1.4	-0.7	-0.7	-0.1	0.7		

* All Western Europe, except Austria, Greece, Ireland, and Portugal.

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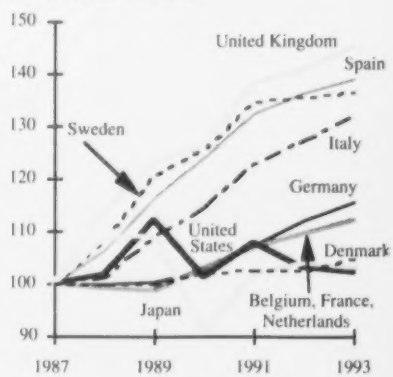
Unit labor costs in DM terms

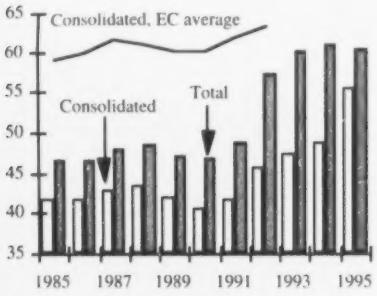
*business sector, 1987=100**



* 1992 and 1993 are OECD forecasts, assuming exchange rates constant at early-August 1992 levels.

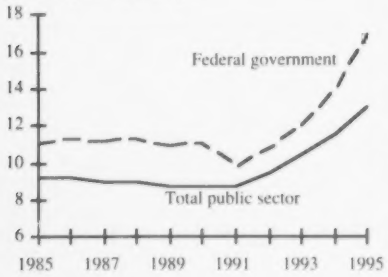
Pan-German public-sector debt

percent of GDP



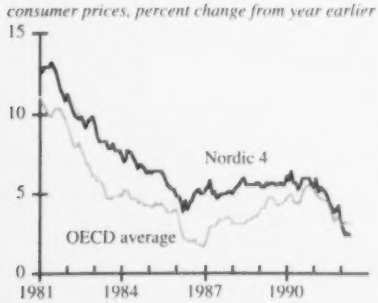
German interest payments

percent of total spending



Nordic deflation

consumer prices, percent change from year earlier



Nordic housing slump

*starts, latest three months, percent change from year earlier**

* Average of Denmark, Norway, and Sweden.

Germany's misleading budgetary optimism

The German government's draft budget foresees a token reduction in the federal deficit to DM38 billion in 1993, from DM41 billion (1.4% of pan-German GNP) in 1992. The red ink subsequently is to fall to DM25 billion by 1996. Germany's current economic stagnation, however, suggests that today's unexpectedly high tax revenues – a legacy of the past economic boom – will not hold up. Allowing also for cyclically higher expenditure (more than the "strict" 2.5% growth officially envisaged), next year's federal deficit is likely to rise – to about DM 45 billion – instead of falling.

More importantly, the federal deficit measure minimizes the severity of Germany's fiscal problem. The official "consolidated" deficit, which includes länder and community spending plus certain unification costs, will be some 4.2% of GNP this year. And the overall public sector deficit, including the large deficits incurred by the Post office, railways, Social Security, and the Treuhandanstalt (the holding entity for former GDR state property), will be in the red by 6.2% of GNP this year – against just 0.6% in 1989 prior to national unification.

Current federal austerity plans promise no speedy or major shrinkage of the overall public sector deficit before 1994/95. By that time, the länder and communities' deficit could swell to 2% of GNP (from zero in 1989), but winding up of the Treuhandanstalt and certain unification-related funds could see the overall red ink down to 3.2% of GNP. The tiers of government in Germany will inherit the cumulative debt of the unification entities. Consolidated public debt will balloon over 55% of GDP – little below the 60% threshold set as one Maastricht criterion for EMU – and debt service will take a fast-rising share of overall German public spending in the years ahead.

Nordic economies now the low inflation zone of Europe

Inflation has fallen below 3% in all four major Nordic economies – Denmark, Finland, Norway, and Sweden. In contrast to the 1980s, when the four's average inflation exceeded the OECD average, Nordic inflation will not be an active policy concern again any time soon.

The sharp drop in Nordic inflation since early 1991 owes much to several years of tight monetary policy throughout the area. As a member of the ERM, Denmark has resolutely followed the monetary lead set by Germany; the other three countries are now committed to exchange rate targets against the ECU.

Tight monetary and fixed currency policies are not the only factors suppressing inflation: witness Finland, which last November devalued the markka by 12.3%; despite this depreciation, its inflation has fallen further – consumer prices rose a modest 2 7% in the year to this June, and should rise little faster over the balance of 1992 and 1993. As important as tight money is the, in some cases, extremely lengthy and arduous fiscal and personal sector adjustments now in progress in the Nordic economies as they re-jig policies to foster private-sector saving and reduce public-sector support for industry. The resulting dramatic spike in private net saving is having severe deflationary implications across the area: construction activity has plunged; real estate prices are falling; corporate insolvencies have jumped; unemployment has risen inexorably; and financial-sector difficulties loom large.

Norway and Denmark entered this period of adjustment as long ago as the mid-to-late 1980s. The severe difficulties they still have in achieving anything more than anemic growth augur poorly for the speed at which the cyclical laggards, Finland and Sweden, will complete their adjustments. These two – especially, Sweden – have far to go to correct unsustainably large fiscal deficits even as real interest rates promise to remain painfully high.

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Asia/Pacific

Japan. New fiscal stimulus (albeit mostly replacing expiring stimulus) will spur a mild recovery starting late this year. It will add about a half percentage point to FY1992's economic growth, but not enough to achieve the government's 3 1/2% growth target.

- Business investment will not turn up before 1993 due to lower profits and higher capital costs, despite lower interest rates. High inventories depress manufacturing. Overtime reductions hurt incomes.
- But surging housing activity is a tonic for both GDP and consumption in second-half 1992, aided by strong household finances.
- Net exports should add substantially to GDP growth in 1992 and 1993, and Japan's huge external surpluses will climb further.

Long-term yen yields – now internationally and historically low– will rise in late-1992, but not substantially amid the expected slow recovery.

- A ¥2-¥3 trillion supplementary budget – 0.6% of GDP – will not threaten the JGB market amid weak private-sector credit demand.

Australia's on-again, off-again, recovery may yet deliver over 2% real GDP growth this year, but has not kept unemployment from reaching 11%. Another round of fiscal stimulus will send the Commonwealth deficit to 3.7% of GDP for 1992/93 – a 5 percentage point deterioration in two years.

- The stimulus need not inhibit lower bond yields nor even further jeopardize the currency, thanks to radically diminished inflation pressures.

Asia/Pacific NICs will again average 6% real GDP growth this year and next. Growth in China, Hong Kong, and Taiwan – all with current account surpluses – will step up and their surpluses slip. India and the Philippines – with deficits – also will grow faster, yet better policies should narrow their deficits. Slowing growth will curb Thailand's huge deficit, but yield little such gain for Korea in a sluggish, fiercely competitive, global economy.

Japan: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1992				1993	Q4/Q4 change	
	1992f	1993f	Q1	Q2f	Q3f	Q4f	Q1f	1992f	1993f
Real GDP	2.3	3.2	3.4	1.5	3.2	3.9	3.2	3.0	3.0
% change over year ago			2.2	1.6	2.0	3.0	2.9		
Private consumption	2.1	2.5	3.4	-1.0	3.6	2.4	2.6	2.1	2.6
% change over year ago			3.3	1.4	1.6	2.1	1.9		
Business fixed investment	-1.0	0.8	-0.2	-2.0	-1.0	0.0	1.0	-0.8	2.5
% change over year ago			-0.9	-0.6	-1.6	-0.8	-0.5		
Residential investment	-2.9	6.6	-0.4	6.1	17.0	12.6	4.1	8.6	2.8
% change over year ago			-13.2	-5.7	0.4	8.6	2.5		
Net exports*	0.7	0.5	-0.1	0.4	0.7	0.6	0.4	0.4	0.4
Change over year ago			0.7	0.6	0.8	0.4	0.5		
Consumer prices (Tokyo)**	2.1	2.3	2.1	2.6	2.0	1.7	2.2	1.7	2.5
Trade balance (sa, customs, $ billion)	103	124	112	98	101	103	120		
Current account (sa, $ billion)	110	128	114	114	103	107	125		

* Percentage-point contributions to real GDP growth. ** Percent change on year earlier.

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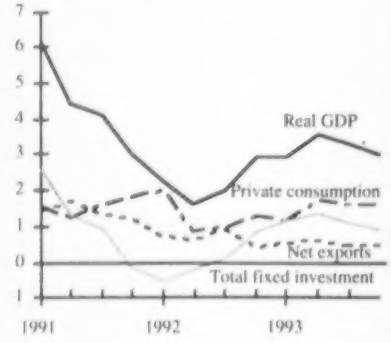
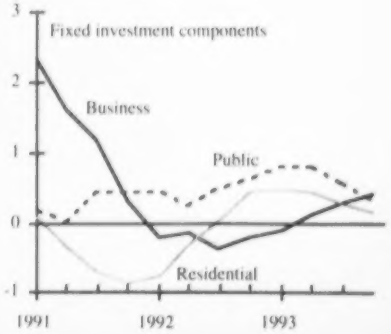
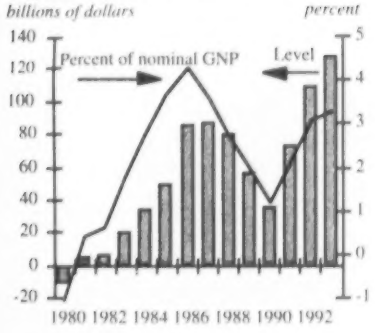
Japan: real GDP growth contributions

from year earlier, percentage points

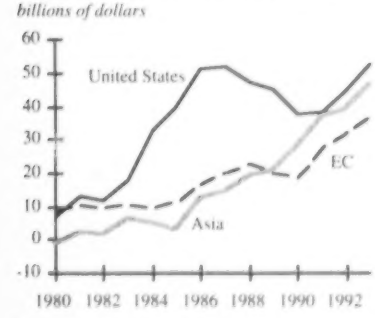




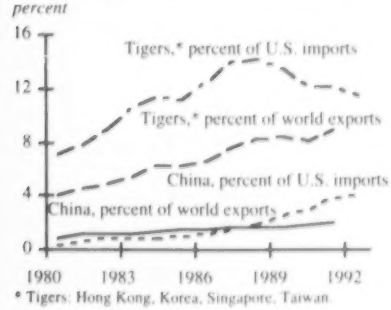
Japan: current account



Japan: bilateral trade surpluses



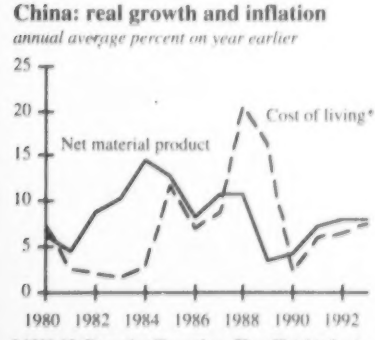
China and the Asian tigers: exports



* Tigers: Hong Kong, Korea, Singapore, Taiwan

China: real growth and inflation

annual average percent on year earlier



* 1990-93: December/December. The official index is widely seen to understate actual inflation.

Japan: current account surplus resurgent

Japan's current account surplus is headed above 3% of GNP this year. From a low of $36 billion in 1990, the surplus will nudge $110 billion for 1992 and could approach $130 billion by 1993.

The initial rise in 1991 owed much to lower imports of gold and luxuries, the fall in oil prices, and reduced official transfers once Gulf War payments ended. More recently, demand sluggishness at home has become the dominant source of the current account's upward trend: from invisibles, supplemented by higher investment income from Japan's accumulation of assets from past surpluses; and, still more, from merchandise trade.

Japan's exports much exceed imports in absolute level and are far more responsive to income determinants than are imports. Cutting the surplus, therefore, requires domestic demand to grow much faster than abroad. Yet for some time to come, domestic demand will grow no more than 3% over a year ago – little faster than in other industrial countries. And even if overall domestic demand picks up smoothly, high manufacturers' inventories in Japan will retard imports. Indeed, export and import volumes will grow at similar rates. This implies a further rise in the surplus in yen terms and – thanks to J-curve effects triggered by the yen's appreciation – a still greater rise in dollar terms.

Bilaterally, Japan's trade surplus with the United States was up 36% from one year earlier in the second quarter of this year. If the U.S. economy is now set for 2%-3% growth, the bilateral surplus will show a clear upward trend. Japan's surplus with Europe jumped about 50% in 1991, as the bursting of Japan's "bubble" economy hit luxury imports; the surplus now is likely to resume its "normal" rise. The other heavy contributor to Japan's increasing overall trade surplus will be its exports to fast-growing Asian countries. Their growth is expected to remain near last year's 7%; and Japanese direct investment in Asian manufacturing sites still is growing, if less vigorously than in some recent years. Both factors will help sustain Japan's overall exports even should U.S. or European demand chance to flag.

China: export prowess, but state enterprises in trouble and economy overheated

China's industrial sector has been a leading beneficiary as the four Asian "tigers" – most particularly, Hong Kong – gradually cede labor-intensive manufacturing to lower-wage rivals in favor of more specialized and sophisticated goods and services. Success, however, breeds its own problems. For China, these include trade frictions with the United States and others externally, and challenging problems of public sector reform and macroeconomic discipline at home.

From a very modest position less than ten years ago, China has emerged as a significant player in world trade. Its share of world exports climbed from 0.8% in the late 1970s to 2.1% in 1991. Following in the steps of both Japan and the tigers, China's export effort is heavily oriented to the U.S. market. U.S. data show the growth in China's U.S.-import market share since 1985 to have eclipsed that of the tigers; indeed, whereas U.S. imports from the tigers have shared in the general stagnation of imports into a very slow-growth U.S. economy since 1989, imports from China have continued to rise. It can be little wonder that China's trade practices draw U.S. protectionist fire, often on human rights and unfair pricing grounds.

Unfair pricing will remain at issue so long as China piles up current account surpluses and international reserves – rather than be a net capital importer, as many believe appropriate for a fast-growing industrializing nation – and while otherwise impressive domestic market reforms stop short of root-and-branch overhaul of its soft-budget, cosseted, state enterprises. Without such overhaul, China's economy may continue to achieve intervals of rapid growth – real NMP jumped 11% in January-May 1992. But it will be prone to inflation, as now, and incapable of steadfast and rational fiscal, credit, and monetary policies.

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Effective exchange rates

*index numbers, 1980-82 average = 100**

	1989	1990	1991	1991 Q2	1991 Q3	1991 Q4	1992 Q1	1992 Q2	1991 Jul	1992 Mar	1992 Apr	1992 May	1992 Jun	1992 Jul
Nominal against 15 industrial-country currencies														
United States	91.3	86.5	85.5	87.7	87.6	84.0	84.8	85.2	88.9	86.8	86.4	85.5	83.7	81.7
Japan	172.8	156.8	170.0	167.6	170.4	175.3	176.9	174.3	170.2	172.9	171.5	173.9	177.4	175.7
Canada	100.5	100.7	102.5	102.8	103.3	103.2	99.5	97.9	103.1	98.7	98.8	97.6	97.4	97.2
Australia	65.6	62.4	61.5	62.3	63.2	61.0	58.5	59.0	63.1	60.1	60.2	58.9	57.7	55.8
Germany	121.0	124.9	124.2	122.9	123.4	125.0	125.2	125.1	122.8	124.9	125.0	124.8	125.4	126.6
France	84.9	88.2	86.8	86.2	86.2	86.9	87.3	88.2	85.9	87.3	87.7	88.2	88.5	89.2
Italy	80.6	81.3	80.3	80.2	79.9	80.2	80.3	79.9	79.8	80.2	80.0	79.9	79.8	80.4
United Kingdom	81.3	79.3	80.0	79.8	79.3	79.3	79.0	80.5	79.1	78.6	79.7	80.9	81.0	80.4
Belgium	94.2	97.7	97.8	97.1	97.2	98.2	98.3	98.1	97.0	98.1	98.1	97.9	98.2	98.9
Denmark	99.0	104.7	103.3	102.9	102.4	103.2	103.2	103.4	102.0	103.0	103.0	103.2	103.9	104.9
Netherlands	113.6	116.4	115.7	114.9	115.2	116.3	116.5	116.2	114.8	116.3	116.2	116.1	116.4	117.2
Spain	78.9	81.8	81.8	81.7	81.0	81.3	81.7	81.9	80.6	81.4	81.6	82.2	82.1	82.2
Sweden	81.2	79.0	78.9	79.1	78.5	79.1	79.7	80.0	78.4	79.6	79.7	80.0	80.2	80.8
Switzerland	115.8	121.3	119.7	120.7	117.9	117.7	115.7	113.3	117.9	114.1	112.5	112.7	114.8	117.4
Real (relative wholesale-price adjusted) against 18 other industrial-country currencies and 22 emerging-market currencies														
United States	96.9	92.7	92.2	94.0	93.8	91.1	91.5	91.5	95.0	92.9	92.7	91.7	90.0	88.2
Japan	121.8	107.8	114.9	113.8	115.4	117.3	117.3	115.3	115.7	114.8	113.8	115.0	117.1	115.6
Canada	107.9	103.5	102.4	103.7	103.3	102.0	99.4	97.9	103.9	99.2	98.9	97.7	97.1	96.8
Australia	98.6	94.8	93.6	94.9	95.6	92.3	87.9	87.6	95.3	89.6	89.6	87.5	85.7	82.9
Germany	105.4	108.7	106.8	105.7	105.4	107.0	107.3	107.4	104.9	106.8	107.1	107.1	107.9	109.6
France	100.7	104.7	103.0	102.0	102.2	103.8	104.4	105.5	101.8	104.3	104.8	105.6	106.1	107.2
Italy	108.1	110.5	107.9	107.4	106.8	107.4	106.9	105.9	106.7	106.3	106.1	105.8	105.7	106.7
United Kingdom	94.6	96.6	100.1	99.4	98.9	99.4	99.6	101.5	98.5	99.0	100.5	101.9	102.1	101.8
Belgium	80.5	85.0	85.6	84.8	85.0	86.8	87.5	86.1	84.7	87.2	85.7	85.8	86.7	86.9
Denmark	106.6	112.1	109.1	108.9	107.4	109.7	108.3	109.0	106.0	108.9	108.7	109.3	108.9	108.6
Netherlands	97.3	99.9	98.8	97.4	98.0	100.3	99.4	101.3	97.0	100.1	101.1	101.0	102.0	103.9
Spain	110.0	116.8	117.9	117.1	116.4	117.7	118.7	118.7	115.4	117.6	118.7	118.8	118.7	119.5
Sweden	105.5	104.0	102.6	102.6	101.9	102.7	103.7	103.2	101.5	102.9	103.2	103.1	103.4	104.3
Switzerland	106.6	115.2	116.4	116.4	114.5	115.6	114.4	112.2	113.9	113.0	111.6	111.2	113.7	116.8
Argentina	50.1	58.9	69.2	69.8	69.2	67.6	66.6	65.8	70.3	67.2	67.0	65.8	64.5	62.9
Brazil	98.5	118.0	90.7	90.3	95.0	85.6	83.1	82.3	94.2	84.2	81.2	83.1	82.5	80.7
Chile	62.4	60.0	65.3	66.1	66.7	65.8	69.8	72.7	67.5	72.3	73.2	72.9	71.8	69.8
Mexico	74.0	69.2	74.7	75.4	76.1	74.2	74.5	75.4	76.4	75.5	75.9	75.4	75.0	74.5
Venezuela	62.1	52.4	51.7	52.4	52.0	52.5	51.3	52.3	51.9	51.5	52.2	52.3	52.3	51.2
Hong Kong	98.8	99.1	105.6	108.1	107.7	108.8	108.5	113.0	108.5	111.7	111.6	114.7	112.8	107.4
Indonesia	55.7	54.8	54.8	55.3	56.4	54.5	55.0	55.6	56.8	56.4	56.7	55.7	54.5	54.5
Korea	92.3	85.1	83.5	85.8	85.1	80.3	78.7	77.2	86.3	79.6	78.6	77.3	75.6	74.9
Malaysia	80.0	76.3	76.1	77.1	77.1	75.9	80.4	83.0	77.7	83.3	83.8	83.3	81.9	81.0
Philippines	95.7	88.8	87.2	85.4	90.6	91.7	94.3	94.5	89.3	95.7	96.6	93.2	93.6	96.2
Singapore	78.2	80.7	83.2	82.8	84.4	84.7	86.4	86.1	84.3	86.6	86.7	86.2	85.3	84.1
Taiwan	100.9	94.1	92.8	93.2	94.1	92.6	93.5	94.0	94.6	93.9	94.2	94.2	93.5	92.0
Thailand	77.7	75.1	78.4	79.9	79.7	76.8	76.4	75.7	80.8	77.0	76.9	75.6	74.5	72.9

* A currency's nominal effective exchange rate is an index of its trade-weighted average value against the currencies of the country's principal trade partners. The real effective exchange rate, which adjusts the nominal index for relative price changes, gauges the effect on the international price competitiveness of the country's manufactures due to currency changes and differential inflation. The relative price changes are based on indices most closely measuring the prices of domestically produced finished manufactured goods, excluding food and energy at the first stage of manufacturing. The weights for the currency indices are derived from 1980 bilateral trade patterns of the corresponding countries.

J.P. Morgan Government Bond Index: total return performance

percent change, end of period from like preceding period

	1989	1990	1991	1990 Q4	1991 Q1	Q2	Q3	Q4	1992 Q1	Q2	May	Jun	Jul
In local currency terms													
United States	14.0	8.6	14.8	5.2	1.9	1.4	5.5	5.3	-1.6	4.0	1.7	1.5	2.4
Japan	-1.5	0.8	13.8	8.8	2.1	0.5	6.1	4.4	1.8	1.9	1.2	1.6	2.4
Canada	12.8	7.4	21.0	6.7	5.9	0.3	7.3	6.2	-1.4	6.1	3.1	2.3	4.6
Australia	13.7	18.8	26.3	8.3	5.3	3.7	6.5	8.6	-1.1	7.9	2.0	2.6	3.6
Germany	1.0	1.1	11.9	2.7	4.1	1.9	2.3	3.1	2.4	1.6	0.9	0.2	0.2
France	4.1	7.3	15.9	4.7	6.4	2.1	3.4	3.2	1.3	1.9	1.7	-0.5	-1.2
Italy	12.0	14.6	17.2	3.1	4.9	3.9	4.0	3.4	3.1	0.7	0.8	-1.3	-2.6
United Kingdom	8.0	9.5	16.8	7.5	6.7	0.8	7.2	1.3	1.5	6.3	2.1	-0.3	-0.3
Belgium	2.0	8.8	13.3	4.0	4.9	2.1	2.9	2.7	2.2	2.3	0.7	0.5	0.0
Denmark	5.0	10.2	16.1	4.0	6.2	2.7	2.9	3.5	1.2	1.4	1.2	-1.0	-1.4
Netherlands	-0.2	3.3	11.4	2.8	3.9	2.1	1.9	3.1	2.9	2.5	0.9	0.5	0.0
Spain	9.2	14.8	17.5	4.6	6.5	4.3	3.8	1.9	3.3	0.6	0.8	-1.2	-2.1
Sweden	2.2	14.8	20.2	7.8	6.1	5.5	5.4	2.0	3.8	1.3	1.5	-0.4	-0.6
ECU	..	7.4	16.2	5.1	5.9	2.5	3.8	3.2	1.3	1.0	1.7	-1.3	-2.6
In dollars													
United States	14.0	8.6	14.8	5.2	1.9	1.4	5.5	5.3	-1.6	4.0	1.7	1.5	2.4
Japan	-14.5	7.2	23.4	11.3	-1.7	2.7	9.9	11.2	-4.4	7.6	5.6	3.1	1.2
Canada	16.1	7.2	21.5	6.4	6.0	1.8	8.2	4.0	-4.2	5.4	2.2	2.8	5.9
Australia	5.1	16.2	24.3	1.2	5.6	2.6	11.0	3.3	0.2	4.7	1.9	1.4	3.1
Germany	5.6	14.8	9.8	8.1	-8.7	-4.2	11.2	13.0	-5.6	9.6	3.6	5.6	3.3
France	8.9	22.4	13.4	8.4	-6.1	-4.2	11.8	12.7	-5.9	10.8	4.8	4.7	1.5
Italy	15.5	28.8	15.1	7.3	-6.2	-2.4	12.4	11.9	-4.4	8.3	3.1	3.7	0.4
United Kingdom	-3.7	31.3	12.8	11.1	-3.6	-6.4	15.7	8.1	-5.7	16.4	5.1	3.7	0.8
Belgium	6.7	25.2	12.0	8.7	-7.3	-4.0	11.8	12.5	-5.5	10.3	3.3	5.9	3.1
Denmark	9.1	25.6	13.5	7.6	-6.4	-3.5	11.9	12.4	-6.3	10.5	4.5	4.6	1.3
Netherlands	4.5	17.2	9.5	8.2	-8.7	-4.1	10.8	12.9	-5.1	10.5	3.3	5.9	3.1
Spain	13.1	31.1	16.6	7.1	-3.4	-2.7	11.6	11.2	-3.9	8.6	4.1	2.9	0.1
Sweden	0.7	26.4	22.2	10.4	-3.0	-0.4	13.3	11.6	-3.7	9.8	4.4	4.6	2.0
ECU	..	24.3	12.9	9.9	-6.6	-4.0	12.3	12.1	-6.0	9.4	4.5	3.7	-0.1
Global	6.8	11.8	15.5	7.0	-0.8	-0.1	8.0	7.8	-3.1	6.5	2.8	2.7	2.2
Global excluding United States	-2.4	15.6	16.0	9.1	-4.3	-2.0	11.4	10.9	-4.9	9.5	4.1	4.2	2.0

J.P. Morgan Government Bond Index: 10-year constant-maturity yields

*percent per annum, semiannual basis**

	1989	1990	1991	1990 Q4	1991 Q1	Q2	Q3	Q4	1992 Q1	Q2	May	Jun	Jul
United States	7.91	8.06	6.69	8.06	8.03	8.23	7.45	6.69	7.52	7.13	7.36	7.13	6.69
Japan	5.59	6.65	5.57	6.65	6.58	6.78	6.07	5.57	5.54	5.51	5.66	5.51	5.24
Canada	9.56	10.28	8.25	10.28	9.52	10.06	9.09	8.25	8.76	8.18	8.40	8.18	7.41
Australia	12.93	12.05	9.39	12.05	11.38	11.16	10.32	9.39	9.85	8.88	9.12	8.88	8.29
Germany	7.26	8.99	8.05	8.99	8.51	8.49	8.38	8.05	8.02	8.01	7.92	8.01	8.16
France	9.37	9.97	8.57	9.97	9.10	9.16	8.87	8.57	8.67	8.80	8.51	8.80	9.22
Italy	14.08	14.54	12.88	14.54	13.68	13.32	12.90	12.88	12.76	13.19	12.67	13.19	14.11
United Kingdom	10.20	10.96	9.75	10.96	10.12	10.49	9.58	9.75	9.87	9.16	8.95	9.16	9.33
Belgium	9.42	9.97	8.88	9.97	9.36	9.35	9.10	8.88	8.87	8.87	8.81	8.87	9.05
Denmark	10.25	10.49	8.73	10.49	9.38	9.28	9.06	8.73	8.90	8.96	8.56	8.96	9.51
Netherlands	7.84	9.15	8.56	9.15	8.73	8.75	8.77	8.56	8.37	8.31	8.27	8.31	8.43
Spain	14.12	14.60	11.27	14.60	12.52	11.94	11.30	11.27	10.91	11.51	10.91	11.51	12.30
Sweden	12.75	12.08	9.90	12.08	11.49	10.70	9.96	9.90	9.48	9.59	9.42	9.59	10.02

* For each of the J.P. Morgan Government Bond Index countries, the data are calculated as the semiannual yield of the single most liquid bond component within four months of the stated maturity.

New York
August 14, 1992

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World Financial Markets
July/August 1992

Global economic outlook in summary

percent change from previous year, except as noted; group averages and totals are for countries listed

	Nominal GDP/GNP	Real GDP/GNP			Consumer prices Dec-Dec			Current account $ billions			% of GDP/GNP		
	$ billions, 1991	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993
Industrial countries	16578	0.8	1.5	2.1	3.6	3.0	3.0	-16.9	-17.9	6.5	-0.1	-0.1	0.0
United States	5678	-1.2	1.8	2.8	3.0	3.0	2.6	-3.7	-45.3	-49.0	-0.1	-0.8	-0.8
Japan	3225	4.4	2.3	3.2	3.2	1.8	2.6	72.6	109.8	127.8	2.3	3.2	3.8
Canada	593	-1.5	1.6	3.1	4.1	2.4	2.4	-23.4	-21.5	-19.2	-3.9	-3.7	-3.2
Australia	301	-2.2	2.4	3.9	1.5	0.4	2.6	-10.4	-8.7	-10.0	-3.4	-2.9	-3.3
Western Europe	6782	1.0	0.8	0.9	4.4	3.8	3.6	-52.1	-52.3	-43.1	-0.8	-0.7	-0.6
Germany	1573	3.2	0.5	0.3	3.9	3.2	3.4	-21.5	-9.4	-5.8	-1.4	-0.6	-0.4
France	1190	1.2	2.2	1.5	2.9	2.8	3.0	-4.8	-5.5	-5.8	-0.4	-0.4	-0.5
Italy	1151	1.4	1.2	0.4	6.0	5.4	5.1	-20.6	-24.8	-26.7	-1.8	-2.0	-2.2
United Kingdom	1041	-2.4	-0.7	1.1	4.5	4.1	3.4	-11.2	-19.5	-20.6	-1.1	-1.7	-1.9
Belgium	198	1.6	1.3	1.3	2.2	3.2	3.0	4.5	5.0	5.3	2.3	2.4	2.4
Denmark	129	1.0	1.2	1.0	2.3	2.5	2.6	2.2	2.6	2.5	1.7	1.9	1.9
Finland	135	-6.1	-1.1	1.5	3.9	3.0	2.6	-5.8	-4.6	-1.9	-4.3	-3.5	-1.5
Netherlands	277	2.3	1.6	1.3	3.9	3.5	3.0	9.5	11.1	12.0	3.4	4.2	4.5
Norway	107	1.5	1.4	2.3	2.8	3.0	3.0	5.0	5.3	5.0	4.7	4.6	4.6
Spain	515	2.4	1.7	1.3	5.5	6.6	5.3	-16.0	-21.7	-17.4	-3.1	-3.9	-3.2
Sweden	238	-1.1	-1.3	0.5	7.9	2.1	1.9	-2.3	-0.5	1.1	-1.0	-0.2	0.5
Switzerland	229	-0.5	0.3	1.0	5.2	3.0	2.5	8.9	9.6	9.1	3.9	4.1	4.2
Emerging markets	3594	1.5	0.8	1.2	101	483	132	-7.5	-39.0	-63.4	-0.2	-1.2	-1.5
Europe	1072	-6.8	-8.9	-8.7	123	1371	328	3.7	-1.1	-8.0	0.3	-0.9	-0.7
Greece	68	1.5	1.5	2.0	17.8	15.0	13.0	-1.5	-1.3	-1.8	-2.1	-1.7	-2.2
Portugal	67	2.3	2.5	2.7	9.6	9.7	6.9	-0.6	0.3	1.7	-1.0	0.4	2.2
Turkey	109	0.3	5.0	5.5	71	60	50	0.3	0.5	0.8	0.3	0.4	0.6
Czechoslovakia	35	-12.5	-5.0	2.0	54	12.5	9.5	0.4	0.7	0.5	1.0	1.9	1.3
Hungary	33	-8.5	-3.3	1.3	34	26	18.7	0.3	0.6	0.3	0.8	1.8	0.8
Poland	80	-10.0	-3.8	-1.5	60	60	45	-1.4	0.1	0.3	-1.7	0.1	0.4
Russia	680	-8.9	-14.4	-15.0	169	2140	500	6.3	-2.0	-9.7	0.9	-1.6	-1.4
Latin America	1010	3.2	3.0	3.7	217	252	109	-16.2	-28.8	-36.9	-1.6	-2.5	-2.9
Argentina	131	5.0	6.5	4.5	84	20.0	15.0	-2.5	-6.5	-10.3	-1.9	-4.1	-4.9
Brazil	403	1.2	2.0	3.0	475	600	250	-2.4	-0.5	-2.8	-0.6	-0.1	-1.2
Chile	31	6.0	7.0	5.0	18.7	16.0	14.0	0.1	-1.0	-1.0	0.3	-2.5	-2.1
Colombia	42	2.3	2.0	3.3	27	26	20.0	2.5	1.0	0.4	5.9	2.2	0.9
Ecuador	12	4.4	2.0	3.3	49	55	34	-0.5	-0.5	-0.3	-3.9	-4.5	-1.7
Mexico	287	3.6	3.0	4.7	18.8	12.5	9.1	-13.3	-17.4	-18.7	-4.6	-5.3	-5.0
Peru	52	2.9	1.0	2.5	139	50	40	-1.8	-2.6	-2.9	-3.4	-52	-4.7
Venezuela	53	10.4	3.4	2.0	31	36	32	1.7	-1.3	-1.3	3.1	-2.2	-2.1
Asia/Pacific	1511	6.2	6.3	6.6	8.6	7.9	7.4	5.0	-9.1	-18.5	0.3	-0.6	-1.1
China	366	7.2	7.5	8.0	6.0	6.5	7.5	12.2	8.0	3.6	3.3	2.0	0.8
India	260	2.0	3.5	4.5	15.5	12.5	9.5	-6.5	-5.8	-5.0	-2.5	-2.3	-1.8
Hong Kong	81	3.9	5.5	6.0	10.0	10.0	8.5	9.3	4.0	-6.3	11.4	4.3	-5.8
Indonesia	119	6.6	5.5	5.5	9.9	7.5	7.0	-4.5	-5.6	-4.9	-3.8	-4.3	-3.5
Korea	281	8.4	7.0	7.0	9.5	9.5	8.5	-8.7	-9.5	-9.0	-3.1	-3.1	-2.9
Malaysia	47	8.8	8.0	8.5	4.2	4.5	4.7	-4.4	-5.2	-2.6	-9.3	-9.0	-4.1
Philippines	46	-0.1	4.0	4.5	13.1	9.5	12.0	-1.0	-2.0	-2.0	-2.2	-3.5	-3.2
Singapore	39	6.7	5.7	6.5	2.9	2.3	2.7	4.2	3.3	3.5	10.7	7.6	7.0
Taiwan	180	7.3	7.5	7.2	4.4	4.0	4.0	12.0	10.0	8.5	6.7	4.6	3.4
Thailand	91	7.9	6.8	7.0	4.7	4.4	4.6	-7.6	-6.4	4.2	-8.3	-6.3	-3.9

Additional information is available upon request. Information herein is believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. Opinions and estimates constitute our judgment and are subject to change without notice. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. J.P. Morgan may hold a position or act as market maker in the financial instrument of any issuer discussed herein or act as advisor or lender to such issuer. Transactions should be executed through a J.P. Morgan entity qualified in the client's home jurisdiction unless governing law permits execution elsewhere. Morgan Guaranty Trust Company is a member of FDIC and SFA. © 1992 J.P. Morgan & Co. Incorporated.

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World Financial Markets

September/October 1992

Europe's growth and currency predicament

September's turmoil expressed the markets' waning faith that policymakers can press forward, or even maintain, Europe's ambitious unity agenda.

- No turnaround beckons for Europe's weakening economies. Instead, contrary to official hopes and consensus views, they will probably show an outright decline in output in 1993.
- The transitional costs of the unity agenda and the strength of deflationary forces bearing on the region continue to be underestimated.
- Interest rates will have to fall sharply Europe-wide to spur even a moderate economic pickup for the region as a whole.

Europe's discouraging cyclical outlook, plus its exposure to intensifying internal and global competition, will keep Europe's joblessness rising fast.

- Joblessness will rise rapidly in coming months. It is unlikely to fall back for years to come, given Europe's poor record in job creation.
- Resulting political strains could stall further progress toward the Single Market – the economic crown jewel of European unity.

Recession and financial setbacks do not, of themselves, foreclose Europe's political aim for broad-scale EMU by the turn of the century.

- Despite jobs fundamentals as poor as any, France, Germany, and other "hard core ERM" survivors remain on track for early EMU.
- Economies that achieve macropolicy discipline outside the hard ERM will win limited output relief with no lasting boost to inflation nor permanent setback to inflation- and bond-yield-convergence.

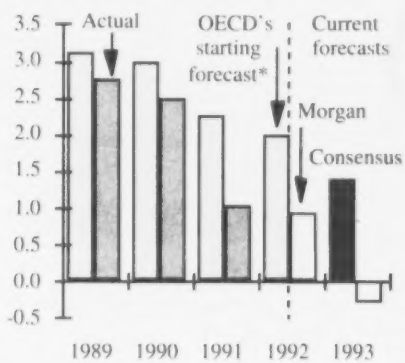
Global economic outlook

The global economy is stuck firmly in an "adjustment" phase for output and employment, with scant reason to believe the end is nigh.

- Even as Europe's currency turmoil redistributes growth and inflation across the region, while depressing its output overall, growth forecasts are being marked down for the rest of the industrial world.
- Many emerging market countries are flagging too, especially in Latin America, but Southeast Asia remains relatively resilient.
- Without substantial policy stimulus, the global economy will not bounce back to its potential growth rate for the foreseeable future.
- The good news: Inflation is waning nearly everywhere.

Major Europe: real GDP growth

Germany, France, Italy, Spain, and United Kingdom, percent on year earlier



*Published in December of preceding year. Consensus forecast from "The Economist," London, October 9, 1992.

Contents

Europe's growth and currency predicament, 3
The deflationary thrust of Europe's unity agenda, 4
Europe's shrinking economies, 9
Macropolicies at Europe's core, 10
The non-core periphery: "reculer pour mieux sauter," 13
Europe's jobs predicament, 16
Conclusions, 17

Global economic outlook, 19
The Americas, 20
Europe, 22
Asia/Pacific, 24

Effective exchange rates, 26
J.P. Morgan Government Bond Index, 27

Global economic outlook in summary, 28

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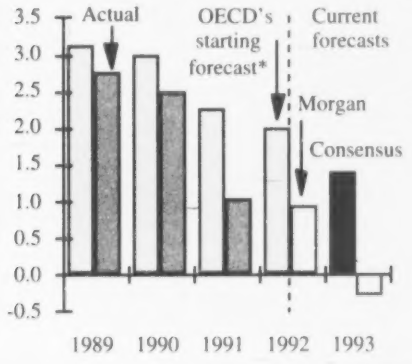
Europe's growth and currency predicament

Chart 1

Major Europe: real GDP growth

Germany, France, Italy, Spain, and United Kingdom, percent on year earlier



*Published in December of preceding year. Consensus forecasts from "The Economist," London, October 9, 1992.

European unity's agenda overload

From	
Early 1980s	Macroeconomic restraint for inflation reduction and fiscal consolidation
1987	Launch of the mission to "complete the Single Market" by end-1992
1989	Emergence of the need to support reconstruction of the old "command" economies of Eastern Europe
1990	German unification
1991	Increasing adherence of the EFTA countries to EC norms (with *de facto* expansion of EC exchange rate principles and management to the Austrian, Scandinavian, and Swiss currencies)
1991	Finalization of the not-yet-ratified "Maastricht" treaty for European monetary and political union

Principal author: Derek Hargreaves, J.P. Morgan, New York

September's market-led devaluations and departures from the Exchange Rate Mechanism (ERM) signaled mounting awareness that, for all Europe's positive accomplishments in recent years, its economies have underperformed official – and market consensus – expectations for output growth since 1989 (see Chart 1). Worse, their prospects for output or employment recovery in the year ahead are decidedly poor. The J.P. Morgan central forecast envisages a small decline in the level of real GDP next year for Western Europe as a whole; almost certainly, it is in outright recession right now.

With hindsight, Europe's growth and currency predicament has arisen as the interim product of an ever-expanding unity agenda – an agenda crowned by the proposed "Maastricht" treaty for European monetary and political union.

The unity agenda's many fine purposes (see box at left for highlights) would have been formidable at the best of economic times. But these have not been the best of times, either globally or for Europe, to step up EC "deepening" and "broadening" simultaneously. In the attempt, Europe's multifaceted agenda has focused more on individual headings than their interaction and macroeconomic consequences, and more on their eventual benefits than the costs of transition. The upshot: strong and relentless deflationary pressure on all the economies of Europe.

This failing has contributed much to the popular disenchantment now jeopardizing the Maastricht treaty. Europe's policymakers underestimated the costs and ramifications of German unification. These, along with past and present policy excesses of some of Germany's partners, are the major causes of Europe's continuing high real interest rates and the acute divergence between a still inflation-fixated Germany on the one hand and a depressed, jobs-starved, rest-of-Europe on the other.

CPI inflation fallout from recent currency changes will be modest, in view of prevailing policy attitudes and margins of slack in most European economies. The fallout will not, by itself, derail underlying inflation convergence. Medium-term inflation prospects for countries outside the ERM core are not inevitably worsened by market-driven currency depreciation; indeed, the record of the 1980s shows that domestic policy and demand fundamentals are the crucial determinants of inflation and inflation convergence outcomes. Nor need recent events permanently inhibit nominal and real bond yield convergence across Europe. Uncertainty premia will recede as markets calm; and real interest rates and differentials will respond to the region's economic troubles.

While ERM realignments and departures are no disaster, neither are they in themselves a solution to the central predicament facing Europe: The policy agenda implies short-run economic and social costs that could well destroy political support for the ultimate unity objectives. Europe's drive for unity can only

succeed by sensitivity to "grass roots" political and economic strains within countries, consciousness of economic cycle interactions across borders within Europe, awareness of the feeble impetus for growth from the global economy at large, and recognition of the extent of the dislocations involved in integration.

The prospect of prolonged economic stagnation now threatens continued progress toward European unity's economic crown jewel – the Single Market. EC 1992 will not achieve its full potential unless decisively stimulative policies – appropriate to the cyclical challenge, realistic on fiscal aims, and radically cutting interest rates – come into place across Europe as German recession deepens.

Financial instability in Europe makes EMU seem a distant dream. Yet, soon after decent economic growth returns, there is little economic (and, correspondingly, less financial) reason to doubt the readiness of today's ERM core group – including France. Thus the third stage of the Maastricht treaty's road to EMU – the irrevocable fixing of exchange rates among a "first tier" of eligible currencies – can still occur by January 1997, as scheduled. The treaty expressly provided for a "second tier" of currencies and countries not meeting its convergence criteria. For these countries, including those not yet members of the EC, inflexible and ultimately unworkable fixed exchange rates are a less convincing showing of "Europeanness" than are balanced macroeconomic policies and patient progress toward Single Market standards.

In all, a "two-speed" Europe has been a reality for years already, and is no bad thing economically in deference to that fact. No doubt it is awkward for some of Europe's political leaders, but it is surely better and more sustainable that European union be built on economic reality and popular support.

The deflationary thrust of Europe's unity agenda

Europe's macroeconomic instability in the 1960s and 1970s, especially after the two OPEC oil shocks, greatly expanded the political constituency for macropolicy discipline in the 1980s. In particular, it fortified Germany's priority for "stability-oriented" policies and performance throughout Europe as the *sine qua non* for ultimate monetary union. The effort to achieve such stability was always bound to impart a deflationary tilt to Europe's macropolicies. What has been less appreciated is the similarly deflationary thrust provided by other deepening and widening features of Europe's unity endeavor, by the faltering global economy of recent years, and the inevitable disappointment of end-1980s' "Europhoria." Thus, each in its own way, the major planks of the unity agenda have compounded deflationary impulses on Europe.

The quest for low inflation. Recalling its inflation excesses 10-20 years ago, which saw even Germany's CPI inflation top 7% for a time in 1981, Europe's progress toward price stability through the 1980s was impressive. That progress has resumed during Europe's business cycle slowdown since 1990 (see Chart 2).

Chart 2

Europe: CPI inflation

percent from year earlier

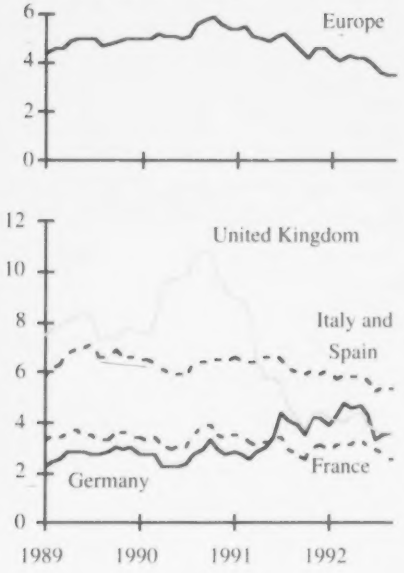
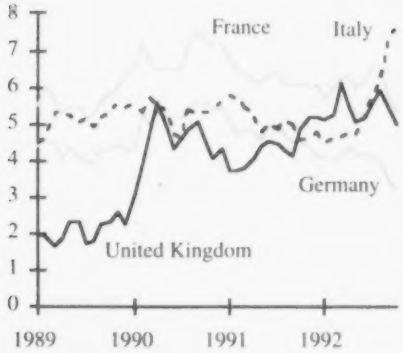


Chart 3

Europe: real interest rates*

percent



*10-year government bond yields adjusted by 36-month centered CPI inflation (actual and J.P. Morgan projections).

Granted, with Germany the laggard in the cycle, its inflation decline from a peak of 4.6% in April-May this year to a recent 3.6% owes more to temporarily lower indirect taxes than its growth slowdown so far; and the relatively modest growth slowdowns experienced until recently in Italy and Spain also have kept inflation from falling much. But in Sweden and the United Kingdom, the economies that have suffered severe and protracted recession, inflation rates have plummeted from double digits two years ago to 2.4% and 3.6%, respectively, last month. Thus German CPI inflation has run *above* the average for the rest of Europe for some time. This is no comfort for Germany, but does represent a remarkable triumph for Europe's inflation convergence objectives.*

None but the most extreme monetarist would maintain that these inflation reductions and convergence would have come to pass without the corresponding deflationary consequences for the real economies of these countries; indeed, the correspondence between inflation improvement and unemployment increase is strikingly exact. At the CPI level, it will broadly survive the inflation impulses dealt by the past month's currency depreciations. Nonetheless, Europe still has some way to go to meet its own inflation goals or the current inflation performance of North America and Japan. And, sooner or later in the global business cycle, it will have to digest the price-raising consequences of an appreciating dollar and yen.

Another key point is that European inflation declines during the last two years have outpaced any declines in nominal interest rates and bond yields. Germany's tough domestically oriented monetary policy has inhibited major falls in nominal rates and yields across Europe. This means that, apart from Germany itself, *real* interest rates have tended to rise, not fall, during Europe's economic slowdown (see Chart 3). They have risen even in Germany from the standpoint of its manufacturing sector, whose pricing now faces increased competitive pressure.

Higher real interest rates contribute a major deflationary thrust reinforcing price discipline but simultaneously aggravating real economy contraction across Europe. Whereas deflation and minimal economic growth were inescapable on a relative basis in the 1980s to bring, say, Belgian and Danish inflation into line with Germany's, it is quite another matter for Europe's overall economic activity when all Germany's partners feel obliged to match or surpass Germany's high real interest rates while Germany itself bears down on inflation at home. Moreover, mere attainment of low inflation, whether in Germany or elsewhere, will not suffice by itself to spawn spontaneous economic recovery in the face of high real interest rates.

The struggle for fiscal consolidation. Rightly judging ever-rising fiscal deficits to be ineffective as a means to social peace, indigestible for financial markets, and other-

*While the "hard ERM" prevailed, such convergence was self-fulfilling for traded goods, but harder to reach at the overall CPI level where services pricing is the dominant yet least tractable influence.

wise counterproductive in the long term, European policymakers have sought fiscal "consolidation" for more than a decade already. They have enshrined this quest in the Maastricht treaty text as at least a soft precondition for first-tier EMU participation.* Yet, whatever the long-term payoff, fiscal consolidation adds to deflationary forces in the short- to medium-run.

Despite official rhetoric, Europe has had a decidedly poor record on fiscal consolidation over the past decade. Its overall discretionary fiscal posture was somewhat restrictive of both deficits and economic activity during the early 1980s, when its GDP growth was low; and roughly as expansionary late in the decade, when growth was speeding up. All told, Europe's aggregate general government fiscal deficit for 1992 – a minimum of 5.2% of GDP by the Morgan projection – will actually exceed the 4.8% previous peak of 1982-83 (see Chart 4). For 1993 Europe faces the choice of either sharply contractionary fiscal actions or deficit outcomes that far exceed any in recent memory.

Recent fiscal deterioration has been sharpest in Germany, the United Kingdom, and Sweden, but has been shared in some degree by nearly all European countries except Denmark and the Netherlands (see Table 1). The major differences: Nearly all the German deterioration is attributable to deliberate fiscal expansion, and much too of the U.K.'s; elsewhere, expanded red ink largely reflects ebbing economic growth, which few countries sought to offset by fiscal tightening until this summer.

Germany's fiscal posture is no longer in expansionary mode, except modestly in this second half of 1992, and is set to tighten next January. Nor is there credible scope for additional U.K. fiscal expansion. Recently Italy, Spain, and Sweden have launched major assaults on their fiscal deficits, whether to impress the financial markets or as a step toward the mandates of Maastricht. Several other countries, including Belgium and Finland as well as Germany, also plan to cut deficits. France expects privatization proceeds to lessen government calls on the bond markets. These efforts – if fully implemented – may or may not reduce actual deficits in 1993 below 1992 levels. The outcome will depend crucially on just how severe Europe's current economic contraction turns out to be – something that fiscal "responsibility" can only deepen and extend. In other words, by demand of the financial markets and officials, Europe's fiscal policies are to be "pro-cyclical" for the indefinite future in the 1990s, just as they were in the 1980s.

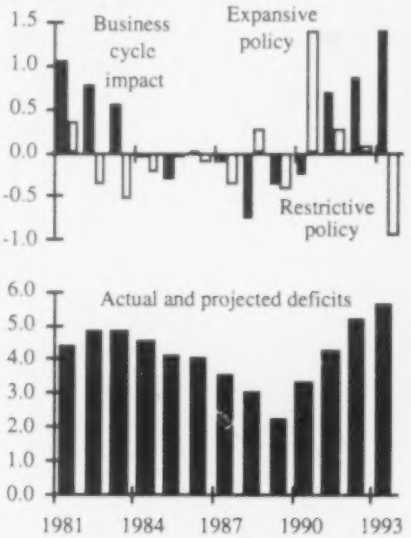
EC Single Market and expansion. Europe's self-confidence soared in the late 1980s under the banner and impetus of "EC 1992" – the project launched in 1987 to complete a Single Market for goods, services, and capital spanning the entire Community by this year. It was agreed to unify primarily by mutual

*Public deficits of 3% of GDP or less and public debt of 60% of GDP or less are the goals, but countries making sufficient progress are not automatically excluded. See "EMU off the Maastricht launchpad," *World Financial Markets*, January/ February 1992.

Chart 4

Europe: policy and business cycle impacts on fiscal deficits*

percent of GDP



*General government (federal, state, and local).

The change in the actual or projected deficit may be viewed as the sum of a business cycle impact (associated with real GDP growth) and a (discretionary) policy impact. Thus the policy impact exhibited above is measured as the change in the cyclically adjusted fiscal balance.

Source: OECD June 1992. J.P. Morgan projections for 1992 and 1993.

Table 1

Europe: fiscal deficits

central government, except as noted
percent of GDP

	1991	1992	1993
Western Europe*	4.3	5.2	5.6
Germany**	4.4	4.4	4.8
France	2.0	2.7	3.4
Italy***	10.7	10.5	9.9
United Kingdom***	2.4	5.3	6.0
Spain*	4.4	5.0	5.5
Belgium	5.4	5.9	6.0
Denmark	4.6	4.5	4.2
Finland	6.1	10.0	9.8
Netherlands	3.8	3.7	4.4
Norway	3.9	6.0	7.8
Sweden	1.5	6.9	9.8
Switzerland	1.5	2.1	2.4

*General government.
**Consolidated basis.
***Public sector.

Chart 5

Europe: business investment

nonresidential fixed capital formation, percent of GDP

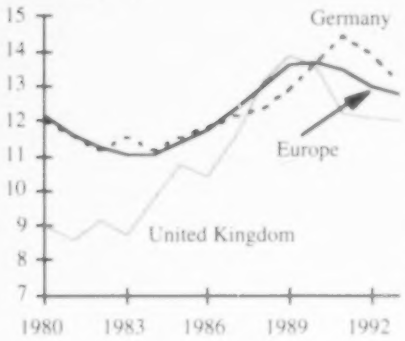


Table 2

Europe: trade integration

average of goods exports plus imports as percent of GDP

	Total		Intra-Western Europe	
	1973	1991	1973	1991
Germany	20	25	14	18
France	15	19	10	13
Italy	15	15	10	11
United Kingdom	19	19	10	13
Spain	10	14	6	10
Belgium	41	60	33	49
Denmark	25	26	19	21
Finland	22	17	15	12
Netherlands	39	45	29	36
Norway	28	28	20	22
Sweden	22	22	17	17
Switzerland	26	28	19	20
Austria	22	28	18	22
Greece	15	22	9	16
Ireland	34	52	27	40
Portugal	21	32	14	26

recognition of existing national standards – that is if France, say, deems a product acceptable, then so shall all EC members – rather than by infinitely tedious harmonization onto a single European standard. This meant that many of Europe's internal barriers to trade and investment met the fate of the "Maginot Line" – effective irrelevance. European business horizons swiftly expanded and an impressive business investment boom ensued. This raised Europe's investment coefficient to heights not seen in more than a decade (see Chart 5).

Investment booms never last forever, and this was no exception. The boom topped out in 1989-90 as high real interest rates precipitated a profit squeeze. Europe's business investment activity is now subtracting significantly from real GDP, amplifying and, in turn, being reinforced by weakness in other demand segments. Moreover, in a process reminiscent of financial service industry responses to the approach and reality of London's 1986 "Big Bang" and of recent and continuing U.S. services sector experience, the visions of boundless business opportunity in a unifying Europe have given way to the depressing reality of excess capacity and the consequent imperative for rationalization and labor shedding; prominent current examples are its steel and automobile plants, its airlines, and the U.K.'s coal mines. For Europe, such adjustment is made all the more difficult by its need to cut back bloated public sectors and public and private subsidies, not to mention the burden of relatively inflexible labor markets. All this promises another protracted negative for economic recovery.

Even so, many tradable goods and services industries now are closely integrated across national borders – especially in such major industries as automobiles. This is confirmed by the increased importance of cross-border goods trade in nearly all European countries' GDP, not least for those countries admitted in the EC's expansion waves of the 1970s and 1980s (see Table 2). The underlying economic benefits of this integration are huge. But integration also speeds the spread of economic shocks. And, in the current environment, cross-border interactions compound the power of deflationary forces – all the more so with the growing *de facto* EC accession of the EFTA economies.

Eastern Europe's nonrecovery. Just as the EC 1992 initiative broadened European business horizons, so did the collapse of Communism in Eastern Europe as it opened the door to 90 million new consumers and producers in Central Europe and hundreds of millions more in the old Soviet Union. Reality, however, has fallen grossly short of once-lofty expectations. Instead, the opening to the old GDR prompted a preemptive rise in the West's real interest rates, while locations further East began gearing up as production alternatives to the West – consequences either negative or transitionally problematic for growth and jobs in the West.

The collapse of unviable state industries in Central Europe, not to mention Russia, so far has out-

weighed the growth of their market-oriented private economies. And external capital flows to the area have not been bountiful. Though Western Europe's exports to the area (excluding the former GDR) have risen sharply in percentage terms (from a very low base) its trade balance has changed negligibly (see Table 3). In other words, for the aggregate Western Europe economy, the "opportunity" of Eastern Europe has proved a mirage so far.

Indeed, it has been less substantive than, say, the private-capital-driven boomlet in U.S. trade with Mexico. Though this boomlet, in "growth accounting" terms, benefited the U.S. economy by just 0.1% of U.S. GDP between 1988 and 1991, it brings efficiency gains for both partners. These gains, which will multiply under the proposed NAFTA, are intrinsically hard to measure, yet may well be large. They owe something to increased gross trade volumes but much also to the generalized benefits of market access and competition. By contrast with the U.S. approach to Mexico, Western Europe has been reluctant to grant Eastern exporters access to its own markets. Instead it has preferred to expand exports to the East by (tied) aid finance. This minimizes efficiency gains for both East and West.

Not until the EC more fully dismantles its barriers to imports from the East, and Eastern Europe comes to rival Mexico and Latin America as a magnet for private international capital, will Eastern Europe's export market and reconstruction be the boon to Western Europe once expected. But in so doing, it will compound the competitive pressures on EC industry already ongoing from the Single Market internally and from Asia and the Americas beyond.

Table 3

Western Europe's opening to the East in global proportion

billions of dollars

	Exports		Imports		Trade balance		
		% change		% change		change from 1988	
	1991	from 1988	1991	from 1988	1991	$ billion	% of GDP*
Western Europe's trade with							
Eastern Europe**	48.5	52	52.2	44	-3.6	0.6	0.01
Germany	244.9	52	268.1	21	-23.2	37.1	0.55
Latin America	26.0	36	3.5	17	-9.4	1.7	0.03
Asia	108.2	-4	177.2	40	-69.0	-55.7	-0.82
U.S. trade with							
Mexico	33.3	61	31.2	34	2.1	4.7	0.08
Latin America	58.9	47	59.6	22	-0.7	8.1	0.14
Asia	115.4	30	194.5	9	-79.1	11.2	0.20
Western Europe	118.1	36	101.8	2	16.3	28.7	0.42

* Percent of GDP of Western Europe or the United States
**The former COMECON area excluding the former GDR.

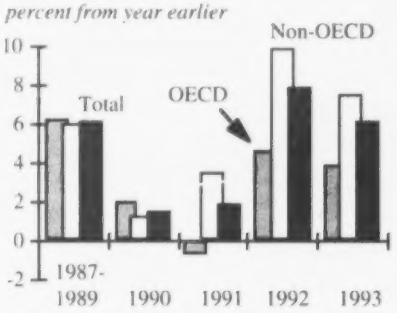
Western Europe's currency appreciation in a slow-growth world. Finally, most accretions to Europe's unity agenda occurred while Europe prospered amid a prospering global economy. That phase ended for the global economy in 1990, ending too the rapid growth of Europe's out-of-area export markets (see Chart 6). Those markets have expanded fast this year on average through some pick-up in North American import volumes and a post-Gulf War surge in the Middle East. That surge, however, is now starting to fade, as too is demand from most other developing and industrial countries.

Equally or more importantly, European producers' loss of competitiveness to U.S. (and Asian NIC) rivals is biting into Europe's world market export shares. On a trade-weighted basis (see Chart 7), the

Chart 6

Europe's rest-of-world export market growth*

percent from year earlier



*Trade-weighted average of goods import volume growths in other OECD and non-OECD countries.

Chart 7

ECU exchange rate

monthly averages, 1990 average=100

*Latest plot: October 19, 1992.
**Versus U.S.$, C$, A$, yen (trade weights proportioned to 1986 bilateral exports plus imports of the EC).

Chart 8

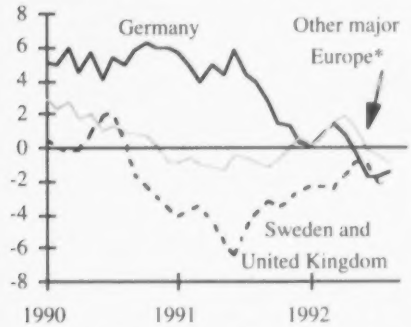
EC trade balance

ECU billions, annual rate

Chart 9

Europe: industrial production

3-month moving average, percent change on year earlier

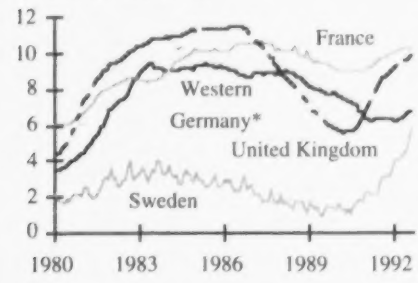


*Belgium, France, Italy, the Netherlands, and Spain.

Chart 10

Europe: unemployment

percent of labor force



* Percent of dependent labor force.

ECU climbed over 70% against non-European currencies from early 1985 through early 1991. And it jumped 14% in the 12 months to this August, before losing more than half that gain during the recent currency turmoil.

Abstracting from the Kuwait invasion spike in oil prices, Europe's trade balance has deteriorated continually and sharply, by more than ECU80 billion since 1986 (see Chart 8). Net external demand for European goods and services subtracted from its real GDP growth by an average 0.8 percentage points annually from 1985 through mid-1990. It would today be subtracting more were it not for stagnating imports – yet another indication of Europe's growth predicament.

Europe's shrinking economies

Just last month, the IMF revised down its forecast for EC real GDP growth in 1992 from 1.8% to 1.4%. It further lowered its forecast for 1993 from 2.8% to 2.3%. Yet, even with these downward revisions, the IMF failed to take on board the deflationary gales blowing in Europe, the uncertainties bred by financial market turmoil, and the message of recent economic indicators from the region.

Europe's industrial production has shown no increase at all since 1990 and now is heading downward (see Chart 9). Sharp declines got under way in Sweden and the United Kingdom that year but were offset through last winter in the aggregate by modest continuing gains in France, Italy, Spain, and – most importantly – Germany. Since last winter, it has become irrefutable that a slide has taken hold in Germany and continues in Sweden; U.K. output has at best leveled out; and negative output trends are developing in France, Italy, and Spain. Orders data also suggest weakening.

Unemployment is rising fast in Europe (see Chart 10). Until 1991, the jobless rolls expanded most in the United Kingdom. The past 18 months have brought some mitigation of the U.K. trend, but no reversal; an unprecedented rise in Sweden; a substantial increase in France; and, since last winter, the beginnings of significant increase in Germany. This bodes poorly for consumer confidence and incomes.

Still another reason to doubt official optimism is, ironically, the sheer success to date of Europe's financial integration. The underlying benefits are substantial.* And the resulting financial convergence has been conspicuous until recently in bond yield spreads (see Chart 11 on page 10) and in increased cross-market correlations. But such correlations constrain short-term policy independence and amplify the spread of financial shocks – hence, no doubt, the new slide in European business confidence following September's currency turmoil, the recent currency measures in Spain, and continuing application of exchange controls in Ireland

*Spurred by dismantling of capital controls and, in any case, dictated by technology and communications advances, integration has forged ahead not only across national borders but within them. The decline of market segmentation and ongoing cost savings and expansion of consumer and investor opportunities are a major economic plus for Europe.

and Portugal.* Indeed, because the breadth and depth of the last many years' integration drive amplify synchronous tendencies across the region, deflationary forces in individual European countries are mutually reinforcing to a degree widely underestimated today.

Altogether, it is the Morgan assessment that Europe is in recession right now, will sink deeper over the next two or three quarters, and will be fortunate to see any growth at all for the year ahead.

Worse, there is scant reason to believe that output recovery, when it comes, will be sufficiently vigorous to ameliorate what will be, by that time, much higher joblessness than today. The problem of joblessness will move from secondary status to centerstage, both economically and politically, as Europe's overall unemployment quickly climbs to exceed its 10.6% peak of the mid-1980s.

It is not only recession that will undermine Europe's employment prospects. The unity agenda – including the Single Market, competition from Eastern Europe, and subsidized competition from East Germany – implies large-scale business restructuring and labor shedding ahead. Europe will not find it easy. It will not have the job alternatives that strong fiscal-policy induced domestic demand created in the United States in the mid-1980s, nor the strong international competitiveness and low interest rates of the United States more recently. In an unrelievedly difficult environment, Europe's adjustment will be substantially more painful. Its recovery will be handicapped by lack of confidence; government budgets will be strained by heavy commitments to income support; and political support will be hard to sustain, let alone expand, for macroeconomic restraint and Europe's broader unity agenda.

Macropolicies at Europe's core

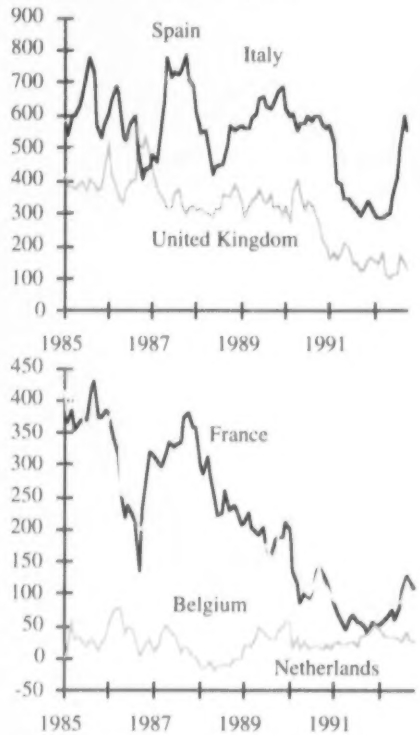
It is against this sour background that European officials will fashion policies in coming quarters. Yet policymakers nearly always feel they have major investments in their choices of the past, whether or not those choices still look optimal for economic recovery from the conditions of today. For the survivors of September's financial market storms – the so-called core ERM economies (Benelux, France, Germany, and probably Denmark) – that means no going back on post-1987 "hard ERM" fixed exchange rate commitments.

The core's German problem. From the very first day, it was inevitable that the unexpected economic costs of German unification after 1989 would ripple across Europe broadly. The German government chose to fund unification by borrowing, rather than by tax hikes that would directly inflate Western labor demands. But the resulting fiscal expansion in what was, two years ago, an overheating economy, has greatly complicated the effort to restore price stability.

Chart 11

Europe: bond yield convergence

*spreads over Bunds, basis points**



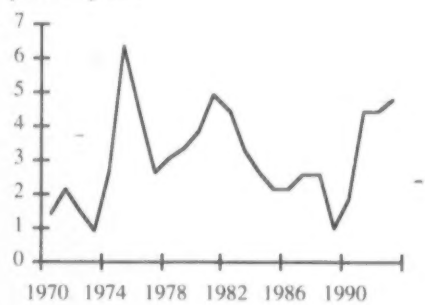
*Constant 10-year Government maturities; nearest available or blended maturities for countries not offering strictly comparable instruments prior to 1987-90.

Latest plot: October 19, 1992.

Chart 12

Germany: budget deficit*

percent of GDP



*Consolidated definition: federal, state, and local governments plus Germany Unity fund, ERP special fund, and debt processing fund. Prior to 1990 data are for Western Germany only.

*Amid disorder and illiquidity, the financial markets fear broader exchange controls and currency free-falls. These fears are overdone. Officials know well that, these days, exchange controls provide little enduring shield from market forces. Besides, markets that overshoot do not for ever lose touch with fundamentals.

Chart 13

Western Germany: demand pressure

volume terms, 1990=100

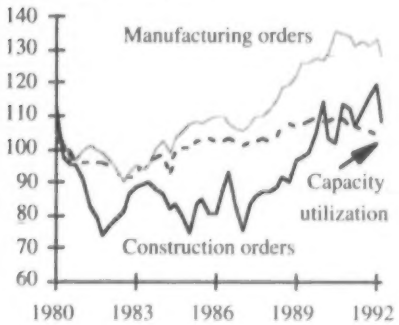


Chart 14

Western Germany: inflation and unemployment

percent

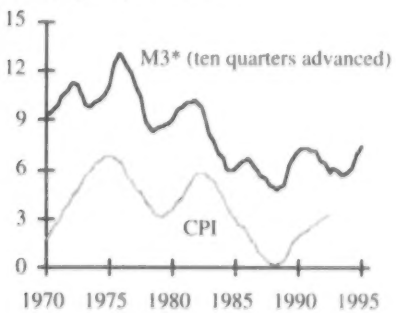
*Percent of dependent labor force.

**3-month moving average, manufacturing.

Chart 15

M3 and consumer prices

10-quarter moving average, percent change from year earlier



*Adjusted for unification base expansion.

And it ultimately contributed to Europe's recent financial turmoil.

Germany's budget deficit on the "consolidated" federal, state, and local definition could edge higher next year, from DM129 billion (4.4% of GNP) in 1992 to DM148 billion in 1993 (see Chart 12).* The hemorrhage blights domestic bond markets and Germany's own long-term economic prospects. Yet, as noted earlier, the deficit is no longer providing much stimulus to the German economy. And its further expansion in nominal terms will be hard to avoid as unemployment rises, despite the VAT increase effective next January. Last month's budget plan looks to halve the federal deficit by 1996 but enjoys scant credibility.

If the German government can yet find a way either to curb spending sharply and convincingly – as previous plans have not – or to scuttle its 1990 tax pledge, the payoff would not be trivial. Not only would the bond markets respond even more favorably than they are already doing on their reading of the economic outlook, but also the Bundesbank would find it less difficult to give benefit of the doubt to monetary easing. This would add credibility to all "fixed" exchange rate commitments in Europe and allow European interest rates to fall more quickly and sharply than they otherwise will under the weight of the business cycle downswing. In turn, other budget sinners – notably Belgium and (beyond the core) Italy, Spain, and Sweden – could tackle their fiscal problems without intensifying recession.

Whatever Germany's choice of policy mix, however, it has no alternative to a period of real-economy underperformance to achieve its low inflation target. At 3.6% in September, Western German CPI inflation is not receding quickly toward the 2% pace that is the Bundesbank's working interpretation of its constitutional stability mandate. Even in 1993, the inflation rate may diminish little:

- Orders and capacity utilization have not yet sunk so low – especially not in the construction sector (see Chart 13) – as to induce price discipline universally.

- Western unemployment has not yet risen to the level that past experience suggests is necessary to curb wage indiscipline convincingly (see Chart 14).**

The Bundesbank now will be cautious lest it ease interest rates too aggressively, following recent weeks' lowering of repo rates – recalling also the past association between fast money supply growth and inflation (see Chart 15). Even so, major rate cuts lie ahead in the context of a German economy in clear recession.

*The red ink would run deeper, were the authorities spending fully up to investment targets. The bulk of spending has instead gone for ostensibly transitional income support. Together, 1993 fiscal outlays for Eastern support and reconstruction will amount to some 4.9% of all-German GNP, with little reduction credibly in sight.

**Western wage moderation to date has been slight, deterred by the notorious rigidity of labor market practices in Germany and the mid-1990s' East-West wage parity goals of organized labor – goals only now coming into question.

No early economic recovery. On this view of Bundesbank policy, neither Germany nor the rest of core-Europe has much chance for economic recovery to begin at all in 1993, whatever Germany's fiscal actions or inaction.

Interest rates and bond yields in the core-ERM economies (including France) will merely lose some of their excess over German levels as financial turmoil subsides. Monetary policies that effectively remain tougher than three months ago – plus currencies that now have appreciated not only against the lira, the peseta, and sterling but also, as significantly, against the dollar and the yen – do not augur strength of either domestic demand or trade performance.

Moreover, while tough monetary policies last, the core's high real interest rates and the probability of still further declines in dollar rates as the U.S. economy stays weak suggest no economic lift from a quick and large appreciation of the dollar. Only by very steep declines in interest rates, which will not come to pass overnight, can Europe's core economies expect to stage much of a comeback – and then only after "long and variable" lags and with all of Europe's structural impediments to job growth applying as much to the core as to the rest of the region.

No expedited EMU. Notwithstanding the difficult economic background and the costs of last month's financial turmoil, the ERM core group displays a seeming commitment and readiness for EMU that encourages thoughts of their expedited progression to monetary union – prior to the third stage of a process that the Maastricht text schedules for 1997.

The core countries probably have the inclination for early EMU whether or not the Maastricht treaty comes into effect. And Austria and Switzerland may have similar ambitions born of past association and compatible economic and financial attainments.

By now, all these countries have a long history of policy fortitude (leaving aside Germany's unification fiscal blowout). Indeed, judged by the core group's responses to September's events, all display the stomach and muscle for fixed rate discipline in the face of extreme speculative pressure. And the current political leaderships (and the monetary authorities) of these countries seem convinced that their sacrifices for price stability have been worthwhile despite chronically high unemployment in Belgium, Denmark, and France, and deteriorating real economic performance for the group at large.

Even so, there are pitfalls on the way to any expedited EMU, or even to the further narrowing of exchange rate bands within the core that is sometimes proposed as a first step (see box). Such narrowing would do little or nothing to advance economic recovery or otherwise improve on the status quo. Indeed, pending economic recovery on a scale that begins to reduce joblessness – a distant prospect today – the governments concerned are unlikely to lavish scarce political capital on speeding up the Maastricht schedule for their own limited EMU.

Pitfalls of expedited EMU

Narrowing of present exchange rate bands within the ERM's shrunken core is proposed as a restatement of commitment to the ultimate EMU objective (perhaps on an accelerated schedule) and, in the meantime, as an aid to price certainty across the core area.

But there are pitfalls to any such initiative:

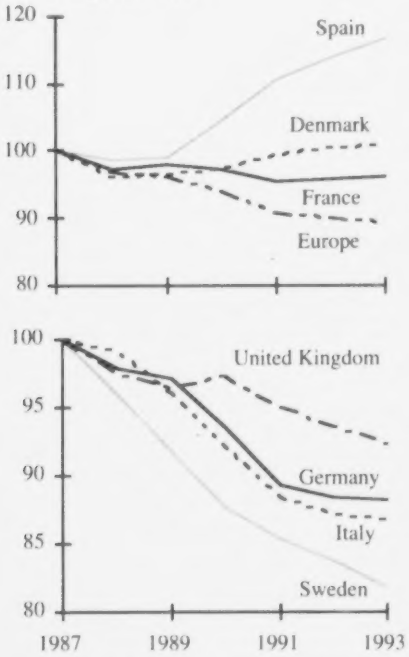
- The political difficulty for intra-European relations of the already strong perception of a privileged German-led zone.
- The control and operational difficulties of overseeing a system of (nearly) irrevocably fixed exchange rates among a subgroup of European currencies in speculative markets – difficulties that the Maastricht treaty text envisages will take time to work out and which are not lessened in principle by being limited to a core group.
- The nagging worry behind the entire Maastricht design: Even for the best qualified aspirants, the third-stage-to-EMU period of "irrevocably fixed exchange rates" may not be trouble-free.

Nothing is irrevocable so long as currencies retain even a shred of separateness. Arguably, the amalgamation of national currencies into a single unit is not assisted by an interregnum of irrevocably fixed rates. It must ultimately be imposed by well-crafted legislative fiat – when, but not before, political institutions are up to the task.

Chart 16

Europe's export performance

total goods exports relative to export market size, 1987=100



Source: OECD June 1992. The projections for 1993 do not allow for recent currency changes.

The non-core periphery: "reculer pour mieux sauter"

Recent events make it improbable that the non-core economies of Europe will qualify for first-tier admission to the third stage of EMU. The non-core group do better, for their own economies and the ultimate grand design for European unity, to revert for some time to pre-1987 "soft ERM" (adjustable peg) or outright floating exchange rate mode.

Competitive disadvantage. In direction, if not perhaps in degree, last month's depreciations of several European currencies against the DM were entirely consistent with one of the most traditional of foreign exchange fundamentals. Under the hard ERM, it was fashionable to declare that trade flows had become irrelevant to currency behavior. But trade flows are not irrelevant to economic performance, and it should not be surprising amid economic stress that trade competitiveness divergences are keenly felt (recall U.S. experience in the mid-1980s).

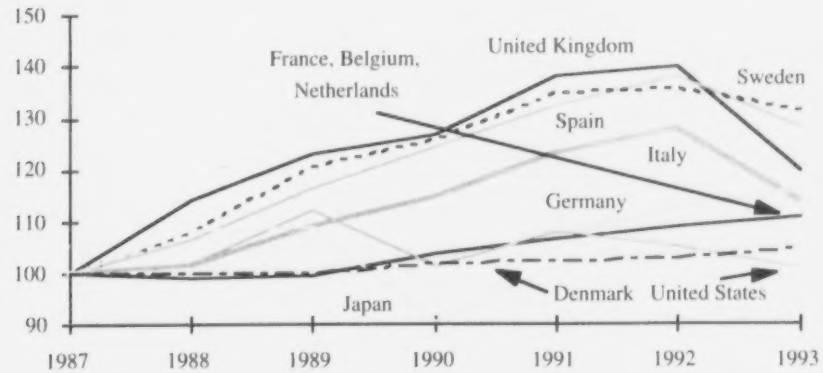
In recent years, not only has Europe as a whole lost ground in global export markets but there has been wide divergence of export performance within Europe (see Chart 16): Italy, Sweden, and the United Kingdom have lost market share, as has Germany; Denmark and France have roughly stayed even; Ireland and Spain have both gained share.* These trade share results mostly correlate with cost and price competitiveness. Chart 17 reveals how relative unit labor costs evolved after 1987 to the significant disadvantage of Italy, Spain, Sweden, and the United Kingdom. Thus there has been ample traditional rationale for these four countries to depreciate their currencies as an aid to restoring competitiveness – a rationale that only Sweden has, so far, resisted.

Still, there are limits to any boost to economic activity that these countries can achieve by currency depreciation – limits set by the subsequent price and exchange rate adjustments triggered by depreciation. Chart 18 (next page) shows that, by the measure of relative producer prices of manufactures, there has been a tendency over the past 10 or 20 years for "real" intra-European exchange rates to return toward long-term historical averages, although not markedly in the

Chart 17

Europe: unit labor costs in DM terms

*business sector, 1987=100**



*1992 and 1993 are OECD forecasts (1992 plots evaluated at average DM exchange rates of January-August, 1992, and 1993 plots at rates of October 19, 1992).

The choice of 1987 as a base refers back to the ERM realignment that year. It does not imply that competitive relationships were thereby equilibrated by the realignment, which in any case did not directly concern nonparticipants in the ERM. Note also that sterling's 1988-92 appreciation against the DM followed a sharp drop from 1986 to 1987.

*Spain's gain largely reflects its integration into the EC. A companion surge in imports will see Spain's current account deficit around 3.5% of GDP this year.

case of sterling.* Today, what stands out are the depressed sterling and lira real exchange rates, the latter to a current level below the past 20 years' experience. This hints that sterling and the lira will revive in due course (as and when markets regain confidence in official policies) or else the United Kingdom and Italy will suffer major excess producer price inflation.

At first sight, the difficulty of achieving lasting changes in producer-price-based real exchange rates within Europe suggests that devaluations are useless as a means to improve competitiveness: If not reversed by the markets, they are simply eaten up by excess inflation. This prevalent wisdom is a half-truth. Competitiveness is more than a matter of selling price; in particular, profit margins in external trade are conditioned by cost trends. Today, with unemployment high and demand pressures low or fading in countries whose currencies have floated or devalued in the ERM, the upward kick from depreciation into traded goods prices will be slow and less than one-for-one any time soon; and labor costs will be slow to follow.

Limited inflation penalties. Overall CPI impacts will be still more muted. In the J.P. Morgan forecast (see table on back page), inflation in Italy will rise from a recent 12-month rate of 5.1% to 6.9% by 1993 Q4, while in Spain it will *drop* from 5.8% to 5.0%, and in the United Kingdom from 3.6% to 3.0%. For Europe as a whole, recession will keep downward pressure on CPI inflation, even after all currencies of the region depreciate against the dollar and yen.

Longer-term outcomes for inflation, inflation convergence, and currency values in Europe hinge on the balance of domestic and external demand against capital and labor resources. Devaluations do not have to undo the good work on inflation convergence since 1987 – especially if accompanied by fiscal restraint. Table 4 summarizes CPI experiences of European countries that devalued in the 1980s, after the high inflation of the 1970s had stiffened their macropolicy resolve and as Europe's unity agenda took broader hold. Two rounds of often steep devaluations, in early- and mid-decade, prevented neither reduction nor convergence of CPI inflation rates. Evidently, inflation convergence need not be a permanent casualty of the demise of the 1987-92 "hard ERM."

*Sterling's average DM real rate since 1980 has been 30% above its 1970-79 average, a difference widely attributed to the U.K.'s petroleum endowment and its tightening of macropolicies in the 1980s.

Chart 18

Real exchange rates versus DM

inflation-adjusted by relative producer prices of manufactures, 1987=100

*October 19: France, 100; Italy, 85; United Kingdom, 94; Spain 106.

Table 4

1980s' devaluations and inflation convergence in Europe

	Depreciation vs. DM, % 1985-87*	12-month CPI inflation minus Germany, percent points Jan 1985	Max	Dec 1988	Sep 1992
Belgium	3	2.8	3.1	0.1	-1.0
Denmark	4	3.6	5.7	2.7	-1.6
France	8	4.3	4.3	1.3	-1.0
Italy	10	6.4	7.0	3.6	1.5
Spain	-20	7.0	10.3	4.0	2.2
Sweden	-17	5.0	6.3	3.3	-1.2
U.K.	-25	2.8	4.8	4.9	0.0
German inflation		*2.1*	*2.6*	*3.1*	*3.6*

	1981-83**	Jan 1981	Max	Dec 1984
Belgium	18	0.9	4.8	3.3
Denmark	12	4.4	6.7	3.6
France	22	6.5	8.6	4.6
Italy	18	12.8	13.9	6.7
Spain	27	8.0	10.1	6.9
Sweden	28	6.1	7.1	6.1
U.K.	18	6.7	6.7	2.6
German inflation		*5.8*	*7.4*	*2.0*

*Jan 1985-Jun 1987. **Jan 1981-Jun 1983. Max: maximum percent points excess 12-month inflation during 1985-87 or 1981-83.

Central bank independence: no inflation panacea

Central bank "independence" can help in principle, and sometimes works in practice, to achieve inflation discipline – witness today's nearly inflation-free (but also nearly growth-free) New Zealand under the Reserve Bank's performance contract with the government.

In most cases, central banks have less clearly defined goals or delegated authority. And, whatever their scope for policy and operational discretion, they can never be truly independent of governmental authorities at some level of accountability.

An independent Bank of England, even supposing that price "stability" were its sole and final mandate, still would have to choose operational intermediate targets (possibly soft) to that end.

Nominal targets more credible to the markets than any of the monetary aggregates, let alone house prices, would seem necessary. Nominal GDP growth is often suggested (and figures in the Federal Reserve's "eclectic" array of criteria). It is difficult, however, to give clear operational content to this particular aggregate. In fact, it is hard to see how the nominal exchange rate could not be a key target for a medium-sized open economy.

Adjustable pegs for currencies. Historically since World War II, apart from the United Kingdom, European countries have been firmly wedded in all but brief periods to (banded) fixed nominal exchange rate ties. The ties sometimes shifted, for example when many countries migrated in the early 1970s from Bretton Woods dollar parities to DM parities in the European "snake." And, until the "hard ERM" came along in 1987, the ties also were adjustable – in some cases, so frequently adjusted as to render the economic significance of the formal fixities questionable.

Yet within or without the ERM, "fixed" exchange rate commitments, including in Spain, Sweden, and (before long) Italy, do provide incentive – but no guarantee – for policies favoring renewed inflation convergence. All three countries are now pursuing fiscal discipline conducive to that end. Thus it would be surprising if any European country besides the United Kingdom now fails to persevere with a "fixed" tie to the ERM. Italy is the current exception, but likely will rejoin relatively soon.

Floating sterling. By contrast, exchange rate floating, as the United Kingdom has now adopted and will likely maintain for a year or two to come, lessens external discipline. The risk – not yet compelling – is that U.K. inflation control will fall victim to a dash for growth that subsequent rediscovery of inflation concerns fails to contain in time.

Containing that risk is now a major challenge for U.K. policy management. One approach, recently canvassed actively, is to endow the Bank of England with hitherto unknown independence. But this cannot guarantee success (see box).

Accordingly, there is much to be said for close monitoring and, before long, targeting of some version of a nominal effective exchange rate for sterling – akin to the "currency basket" approach pursued for a number of years by Finland, Norway, and Sweden. This paved the way to their switch to an ECU reference last year. Admittedly, this approach and then the ECU reference went aground late last year for Finland, and is surely painful today for Sweden. The lesson, however, is not that the effective rate tie was ill advised, but that it may have to yield in the face of extreme shocks. Plainly, such shocks cannot be predicted. But some kind of nominal tie for sterling would seem vital for controlling U.K. inflation expectations and would assist sterling's eventual return to the ERM once convergence of the real economy cycle is sufficiently advanced in an upward direction.

Economic prospects outside the core. Currency depreciations against the DM will help tradable goods industries in the countries concerned and give some small latitude for better overall economic growth. Still, it is far from clear that devaluations and departures from the ERM will durably real interest rates in these economies to fall durably – if at all – below the German level.

To the contrary, there is considerable risk that governments will attempt to defend nominal exchange rates at levels too high for domestic

confidence and economic benefit. Arguably, this risk is reality today for Sweden: Rather than let go of an ECU parity level it adopted in happier times last year, its response to currency market pressures has been a (now reduced, but still draconian) rise in interest rates that could cause its already shrinking economy to implode.

For the longer haul, the periphery economies are mostly beholden to Europe's overall performance, whatever their national choices. Well-judged choices will contain the economic damage to them of Europe's cyclical downswing without undue backsliding on the nominal convergence criteria of Maastricht for inflation, bond yields, and budget deficits. September's events having shattered remaining illusions of an easy ride to monetary union and economic prosperity, this is the reality of life in a Europe that is now formally "two-speed" and "variable geometry" – ironically, as clearly set forth in the text of Maastricht.

Europe's jobs predicament

Since the Danish referendum last May, Europe's policymakers have focussed on resurrecting the Maastricht treaty. And the financial markets have rudely reassessed the chances that the nation states of Europe will observe the treaty's inflation, fiscal, bond yield, and currency convergence criteria for EMU eligibility. All these major economic and financial criteria address *nominal* performance.

What the Maastricht text omitted is at least one further convergence criterion: one addressed to *real* economic growth. The hard fact is that it will be impossible to push forward with Europe's unity agenda while national economies are both "out of sync" with one another and, collectively, heading deeper into recession. The rising tide of joblessness across Europe not only jeopardizes treaty ratification in any form at all but also brings back to new relevance the caricature of the mid-1980s: "Eurosclerosis" – shorthand then and now for the immense structural challenge facing Europe to adapt to intensifying global economic competition in ways that deliver globally competitive returns to capital plus jobs adequate in both number and productive value.

Today, this overriding structural challenge – implicit in key aspects of Europe's unity agenda (the Single Market, Eastern Europe and former Soviet Union reconstruction, and EC enlargement), as well as the Uruguay round of global trade negotiations and the fact of increased competition from North America and Asia – is more ambitious than in the mid-1980s. Yet it is being tackled amid a less supportive global economic environment and with Europe's own economies weakened by the (otherwise well intended) legacy of efforts to discipline the inflationary boom of the late-1980s.

Those disciplinary efforts and goals render Europe much less able than the U.S. economy to cope with necessary restructuring. In the early 1980s, U.S. macropolicy in effect accelerated structural adjustment by a mix of monetary stringency and aggressive fiscal stimulus. Paralleling the Bundesbank's tough

Chart 19

Europe-U.S. unemployment

percent of labor force

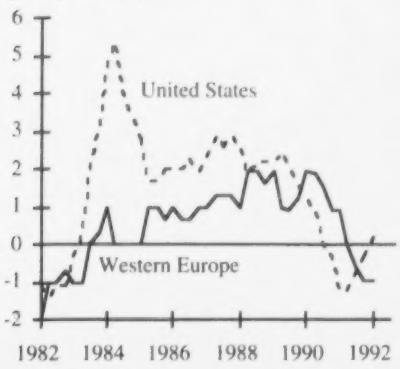
monetary stance today, Federal Reserve policy then was resolutely counterinflationary and helped foster extreme currency appreciation that heightened external competitive pressure. But, unlike Europe's fiscal stance today, U.S. federal budget policy ten years ago intensified a rapid increase in defense outlays and provided major "supply-side" tax cuts and incentives. The combination worked to balloon effective demand for output and labor in the service sector of the economy. Helped too by the microeconomic flexibility of its labor markets, the U.S. service sector absorbed both fast growth of the labor force overall and many of those displaced by the inevitable restructuring of the manufacturing sector. U.S. overall employment soared and unemployment dropped sharply (see Charts 19 and 20). More recently, as the U.S. economy struggles with job losses related to broader restructuring efforts that include many service industries, it benefits from the strong global competitiveness that its low interest-rate, weak-currency, environment provides.

Today, there is little reason for faith that Europe's grim near-term economic prospects are prologue to a bright medium-term future for the region. Europe enjoyed no U.S. "jobs miracle" ten years ago, nor does it now have comparable scope for strongly stimulative fiscal policies. To the contrary, it retains a macropolicy disposition that, by giving primacy to financial discipline, sustains a level of currency overvaluation that leaves too much of its human and physical capital stock uncompetitive. Indeed, the large increases in unemployment that are the inevitable product of Europe's current recession will be difficult, if not impossible, to reverse for several years into the next cyclical upturn, once that finally gets under way.

Chart 20

Europe-U.S. job creation

total employment, percent change from year earlier



Conclusions

Europe's jobs predicament has several major implications for the unfinished unity agenda:

- **Devaluations and departures from the ERM amid cyclical disparities and gathering economic downturn are a worthwhile sacrifice to help sustain the Single Market over the long haul.** The Single Market – minimally modified to accommodate subsidiarity – is the economic crown jewel of Europe's union ambitions. Its successful extension throughout the existing EC – and more broadly across Europe East and West – depends on satisfactory overall economic performance in the great majority of countries within the region, not narrow financial or exchange rate criteria. For those seeking to climb onto the Europe bandwagon, neither Brussels nor individual governments would be wise to make ERM/EMU accession a condition of, or principal rationale for, Single Market or political involvement.

- **Europe's policymakers must take account of the deflationary forces besetting the region from within and without.** What counts most for Europe's economic performance is the aggregate cast of macropolicies and deflationary/inflationary pressures, not just those specific to each

tract of national turf. Moreover, the long-term benefits of Europe's deepening and broadening should not preclude attention to the interactions and short-term costs of the unity agenda.

Commitments to fixed exchange rates within the region have been based largely on how these force individual temptation-prone governments to 'do the right thing' to control inflation and fiscal deficits inimical to long-term saving, investment, and productivity. But in a deflationary world where more and more governments are applying the same religion individually, the results are contractionary of output and jobs. That is not a survivable bottom line for Europe's nominal convergence efforts.

One lesson is that it is none too soon for European central banks to take account of the broader European consequences of their monetary actions. Those broader consequences are critical for the economic performance of their own economies. If concern for those consequences must wait for unity proper, that unity will never be accomplished.

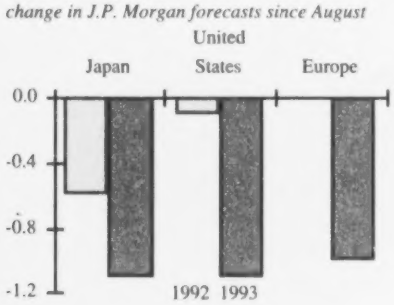
- **Economic recovery in Europe will call for a major redirection of policy toward support of economic growth, including by radical falls in interest rates.** For some, this will entail at least a temporary setback to inflation convergence, and for virtually all to (non-cyclically adjusted) fiscal progress toward the Maastricht goals. If deliberate fiscal stimulus is ruled out, as seems wise in view of the huge deficits already being incurred, the extent of interest rate reductions (and, probably, exchange rate adjustments) conducive to economic recovery across the region will be all the greater. Besides, it will be far more effective to address the job shortage through interest and exchange rate adjustments that enhance aggregate demand than to backslide on the Single Market or other structural adjustments necessary to advance Europe's global competitiveness.

- **September's events are not fatal to EMU.** The Maastricht treaty has a two-tier vision of evolution to monetary union. And in this it has proved more prescient than many of its signatories. On economic grounds, and probably financial ones too, the surviving ERM core group of countries, including France, remain on track for the third stage of EMU as prescribed in the proposed treaty. As for the second-tier group, its numbers are larger than Euro-enthusiasts once hoped. But with no credible long-run alternative in sight, they have both the incentive and now a better chance to resume convergence progress outside the "hard ERM" straitjacket for a time. For them, it is well to remember that France went through several devaluations with generally falling inflation prior to 1987, yet now looks a fairly good bet for early EMU. If today's second-tier group can sustain macropolicy restraint over the next year or two until their economies are once again growing solidly and in line with the core group, their accession to EMU by the turn of the century still may be feasible.

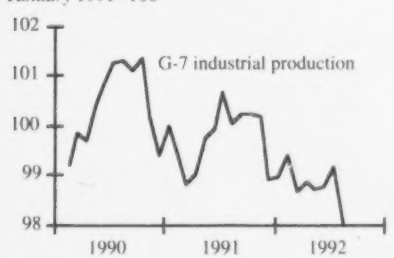
World Financial Markets
September/October 1992
Philip Suttle (1-212) 648-3078

Global economic outlook

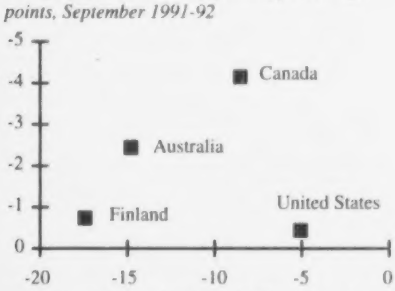
Real GDP growth forecasts sink ...
change in J.P. Morgan forecasts since August



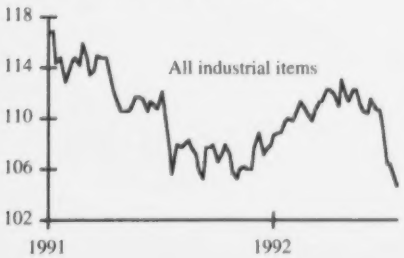
... as actual output declines
January 1991=100



Inflation falls even where currencies depreciate
change in 12-month CPI inflation, percentage points, September 1991-92



Commodity prices plunge
Economist index, dollar terms, 1985=100



Without substantial policy stimulus, the global economy will not bounce back to its potential growth rate for the foreseeable future.

- Following policy and performance setbacks since August, J.P. Morgan's 1993 real GDP growth forecasts for the three major OECD blocks have each been scaled down about 1 percentage point.
- Europe looks to have entered a mild recession this past summer; the United States shows no sign of growth above the meager 1.5% trend of the past year; and, in Japan, private sector demand is weakening by more than the stimulus added by the government.
- Many emerging markets are flagging too, especially in Latin America. But Southeast Asia remains relatively resilient to global downturn.

Europe's currency turmoil will redistribute economic growth and inflation across the region, and undermine its growth overall.

- Macropolicies have mostly tightened in response to the turmoil. Short-term interest rates are generally higher and fiscal policy tighter.
- Consumer and producer caution under a new dimension of uncertainty will weaken final demand and bloat inventories in the months ahead.

The rest of the industrial world shows no convincing signs of recovery.

- In the United States, employment is stagnant in the economy as a whole, and falling once again in the manufacturing sector. Inventories are rising and will need to be pared back in coming months.
- In Japan, consumer spending has slumped and, rather than falling, stocks of finished goods continue to accumulate. As expected, fiscal policy has loosened. But government demand is increasingly substituting for, rather than stimulating, private demand.
- In Australia and Canada, promising recoveries have run out of steam, and will not be helped by recent increases in market interest rates.

The good news: Inflation is waning across most of the global economy.

- As output growth drops below potential and unemployment rises, even countries with depreciating currencies face very little inflation pickup.
- The new slump in commodity prices, plus the competitive pressures of demand weakness, make for low manufacturing cost inflation.

The global economy is stuck firmly in an "adjustment" phase for output and employment, with scant reason to believe the end is nigh.

- The debt "excesses of the 1980s" still overhang many of the OECD economies. Past or present inflation and fiscal excesses overhang the same or other OECD economies and many emerging market nations.
- In what is now, for the most part, a low-inflation world and an increasingly competitive global trading environment, adjustment pressures become ever more intense on businesses and economies judged out of line in the marketplace. Survival and prosperity will demand agility; and the penalties on profits and jobs of the inflexible will be severe.

The Americas

United States. Hopes have faded that the economy will accelerate toward year-end: Slower rather than stronger growth is in prospect for the current quarter. J.P. Morgan's forecast for the first half of 1993 also has been revised down, from 3% (seasonally adjusted annual rate) to 1.5%.

- Negative inventory forces are in full swing right now.
- Consumption in the early quarters of 1993 will lack normal support from tax refunds, inasmuch as tax withholding – but not tax liability – was reduced last winter in an effort to stimulate the economy in 1992.
- Export prospects in the quarters ahead are likely to lose from the slowing of markets abroad more than they gain from a low dollar.

Continued subpar growth and rising unemployment will continue to reduce U.S. inflation. Core inflation down to 2% should be in place by end-1993.

Canada's economy has been beset by a series of negative shocks to already sluggish growth.

- Interest rates are up sharply to stem currency weakness. With inflation very low, and not apt to rise, real short-term rates run 6%-7%.
- Exports will flag as U.S. import volumes shrink in the months ahead.
- Constitutional reform uncertainties blight Canada's bond markets.

Latin America's leading economies are cooling. Tighter policies are slowing growth in Mexico. Industrial production growth is slowing from boom pace in Argentina. Political uncertainty hangs over Brazil.

- Rejecting a heterodox "shock" alternative, Brazil's new administration is to retain much of the Collor economic program. More doubtful is its ability to push through fiscal adjustment and structural reform.

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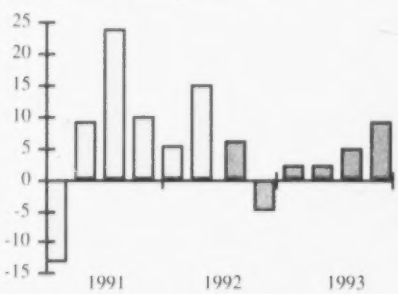
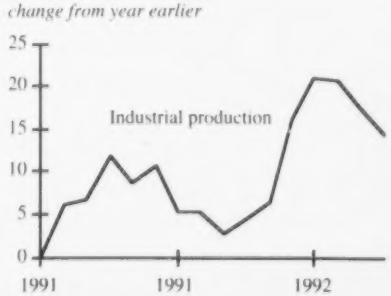
Canada's key export market loses steam

U.S. non-oil import volume, annual rate
percent change from quarter earlier



Argentina's boom starts to fade

3-month moving average, percent
change from year earlier



The Americas: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

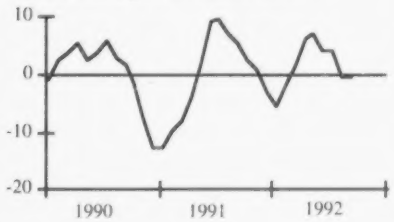
			1992			1993		Q4/Q4 change	
	1992f	1993f	Q2	Q3f	Q4f	Q1f	Q2f	1992f	1993f
United States									
Real GDP	1.7	1.7	1.5	2.0	1.0	1.5	1.5	1.9	2.2
Private consumption	2.0	1.7	-0.1	3.9	0.7	1.3	1.3	2.4	2.1
Business fixed investment	0.9	1.5	16.1	-8.9	2.2	1.6	1.6	2.7	2.8
Residential construction	12.3	5.2	12.6	2.2	6.2	8.5	2.6	10.1	4.2
Inventories*	0.3	0.3	1.7	0.5	-0.4	0.1	0.2	0.0	0.4
Net exports*	-0.4	-0.1	-1.8	-0.4	0.6	-0.1	0.1	-0.4	-0.1
Consumer prices	3.0	2.2	3.4	2.6	2.4	2.0	2.0	2.8	2.0
Civilian unemployment rate (%)	7.5	8.0	7.5	7.6	7.8	8.0	8.1		
Trade balance FAS/CVB ($ billion)	-83	-97	-84	-98	-91	-94	-92		
Current account ($ billion)	-56	-69	-71	-65	-65	-68	-65		
Canada									
Real GDP	1.1	2.3	0.7	1.5	1.9	2.2	2.7	1.3	3.1
Consumer prices**	1.5	2.2	1.4	1.4	1.8	2.1	2.2	1.8	2.3
Mexico									
Real GDP**	3.6	2.6	1.5	2.0	1.8	0.5	0.6	1.8	4.0
Consumer prices**	11.5	8.5	16.0	15.4	11.5	9.9	9.6	11.5	8.5

* Percentage-point contributions to real GDP growth. ** Percent change from year earlier.

U.S. manufacturing output dips again ...

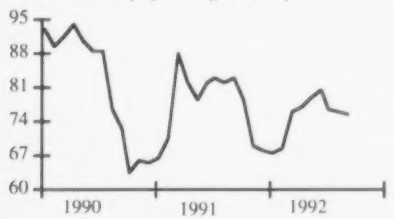
3-month moving average, annual rate

percent change from 3 months earlier



... as does U.S. consumer confidence

index, University of Michigan survey



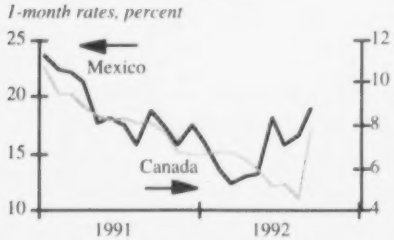
Effects of 1992 U.S. fiscal policy changes

billions of dollars, annual rate

	1992		1993
	1st half	2nd half	1st half
Total added to consumers' income	27	32	-7
Withheld taxes	15	22	22
Tax refunds	0	0	-36
Emergency unemployment benefits	13	10	8

Short-term interest rates in Canada and Mexico have risen ...

1-month rates, percent



... even though their economic growth has slowed

percent change from previous year

Renewed signs of weakness point to continued U.S. growth recession

The fourth quarter is shaping up to be the weakest for U.S. real GDP growth since the slim 0.6% (saar) of late 1991. Nor will growth build steam in the first half of next year. This will leave unemployment – currently 7.6% – drifting upward to above 8% in the middle of 1993.

Signs of present output softness are most evident in manufacturing. Inventories – especially finished goods – have risen significantly recently (which helped third-quarter output) and already seem to be prompting new production cut backs. The associated decline in manufacturing payrolls is contributing to overall employment weakness. This, in turn, undercuts consumer confidence anew.

Low confidence makes it difficult to believe that the recent growth in retail sales will prove sustainable in overall consumer spending. The sales gains reflect both the natural volatility of the data and the beginnings of replacement demand stimulus effects of Hurricane Andrew.

Though these are expected to boost real GDP growth by about 0.5 percentage point in both the fourth quarter of 1992 and the first quarter of 1993, the stimulus will be only transient.

It is difficult otherwise to find any grounds for optimism on a U.S. growth pickup in the first half of 1993. Export growth – one of the key supports of U.S. GDP growth in recent years – shows clear signs of flagging and will suffer from the poor economic growth outlook in Canada, Europe, and Japan.

Domestically, the brief fiscal boost to 1992 demand from unemployment benefit extensions and reduced tax withholding since early 1992 will shortly fade. In fact, it will give way in the early months of 1993 to below-normal refunds on taxes due next April. This will put a noticeable hole in consumers' incomes in the first half of the New Year. Any post-election fiscal package likely will not become effective until well into 1993.

Monetary tightening dampens growth expectations in Canada and Mexico

Having fallen steadily through 1991 and into early 1992, short-term interest rates have risen significantly in Canada and Mexico. For both, monetary tightening reflects external considerations.

Canada's monetary authorities have tightened to stem a depreciation in the currency occasioned partly by investor uncertainty ahead of the October 26 referendum.

Mexico's government has raised its priority for current account deficit containment and for single-digit annual inflation. Toward the latter, it continues to hold the peso stable against the U.S. dollar. The consequent real appreciation of the peso means that reduction of a current account deficit that may run 6.6% of GDP this year depends now more than ever on limiting growth at home.

Monetary tightenings in both economies come against the background of slowing economic growth. Canada's real GDP growth has stalled since reaching an uninspiring 2% (year-over-year) in early 1992. Mexico's industrial output growth also has lost momentum. For both countries, the weakness of activity in its major trade partner (the United States) is providing an external drag on growth. And fiscal policies provide a domestic drag: For Mexico, the fiscal surplus targeted for the whole of 1992 was achieved in the first half.

In coming months, Canada and Mexico will feel fuller effects from their macropolicy tightenings and suffer export weakness as U.S. imports further flag. Their growth expectations will need to be scaled back. In Canada, real GDP growth is expected to be only 1.1% in 1992 and 2.4% in 1993, or 0.5 and 0.7 percentage points weaker, respectively, than projected in August. For Mexico, the revisions are more significant: 3% to 2.6% in 1992, and 4.7% to 2.3% in 1993.

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Europe

Western Germany has entered a period of mild recession. J.P. Morgan's forecast implies a 1.6% real GNP decline from the 1992 Q1 peak to a 1993 Q2 trough. This would be the mildest recession on record: Real GNP fell a cumulative 2.2% in 1966-67, 3.2% in 1974-75, and 2.1% in 1981-82.

- The labor market, however, will see a significant shakeout. Unemployment – now 6.8% – should rise to exceed 8% by end-1993.
- The Bundesbank has begun to shift its monetary policy focus, easing short-term interest rates within the existing rate structure. Though large declines in key official rates remain unlikely near-term, especially while inflation remains in the 3.5%-4% range, market interest rates may well sink further toward the 8.25% discount rate level.

The other major European economies will be dragged down by many of the same influences weakening Germany.

- Significant cyclical disparities will persist, most of all challenging the United Kingdom and Sweden. Until September, the two faced similar problems and a similar outlook. Now, the break in U.K. policy should revive its economy into 1993. By contrast, Sweden's severe austerity measures to defend the krone will accelerate its economy's decline and take unemployment above the 10% U.K. rate next year.

Inflation in Western Europe will not be much affected by recent currency turmoil. Domestic conditions are the primary near-term influence, and the economies whose currencies have fallen still retain high real interest rates.

Eastern Europe's stepped-up efforts to break into Western markets are showing up in more encouraging industrial production trends.

- The steep declines in the industrial sectors of the central European economies – Hungary, Poland, and Czechoslovakia – appear to be over. Low prices are their key strategy; one that puts further pressure on struggling firms in Western Europe's basic industries.

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Europe: real GDP forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1992			1993		Q4/Q4 change	
	1992f	1993f	Q2	Q3f	Q4f	Q1f	Q2f	1992f	1993f
Major 4	0.7*	-0.2*	0.2	-0.3	-0.9	0.0	0.0	0.3	0.7
% change from year earlier			1.0	0.6	0.3	-0.5	-0.6		
Western Germany (GNP)	1.0	-0.8	-0.2	-0.2	-0.7	0.0	-0.6	0.8	0.1
% change from year earlier			1.1	1.0	0.8	-1.1	-1.5		
France	1.8	0.0	0.9	0.8	-0.8	-0.4	-0.4	1.0	0.2
% change from year earlier			2.2	1.4	1.0	0.1	-0.2		
Italy	1.1	-0.5	0.8	-2.0	-1.2	-0.8	-0.8	0.0	0.7
% change from year earlier			1.6	0.7	0.0	-0.8	-1.2		
United Kingdom	-0.9	0.9	-0.4	0.0	-0.8	1.2	2.0	-0.8	1.9
% change from year earlier			-0.7	-0.8	-0.8	0.7	1.2		

* All Western Europe, except Austria, Greece, Ireland, and Portugal.

Central Europe: industrial production

percent change from year earlier

Europe's monetary conditions are tighter ...

change between 1992 Q2 and October 23

	3-month interest rates, basis points	Exchange rates, % versus $	effective
Europe	-18	0.4	
Germany	-88	6.9	4.6
France	2	6.3	4.9
Italy	199	-8.0	-11.5
United Kingdom	-243	-10.2	-13.3
Spain	174	-5.7	-7.4
Belgium	-106	6.8	3.6
Denmark	7.3	4.8	88
Netherlands	-81	6.9	3.8
Sweden	229	2.2	0.1
Switzerland	-294	9.4	7.3

... and its fiscal policy more contractionary

thrust of recent fiscal measures (- = contractionary), percent of GDP

	1992H2	1993H1
Europe	-0.3	-1.6
Germany	0.5	-1.5
France	0.7	0.0
Italy	-3.0	-5.3
United Kingdom	0.5	0.5
Spain	-0.5	-2.0
Belgium	-0.5	-1.0
Netherlands	-1.0	-0.3
Sweden	-0.5	-4.0

Real GDP growth forecasts are down ...

change in annual growth forecasts since August, percentage points

	1992	1993
Europe	-0.1	-1.1
Germany	0.5	-1.1
France	-0.4	-1.5
Italy	-0.2	-0.9
United Kingdom	-0.1	-0.2
Spain	-0.2	-2.4
Belgium	-0.3	-1.0
Denmark	0.0	-1.0
Netherlands	-0.1	-0.7
Sweden	-0.7	-3.6
Switzerland	-0.8	-1.0

... but inflation forecasts change little

change in annual growth forecasts since August, percentage points

	1992	1993
Europe	0.0	0.2
Germany	0.1	0.0
France	0.0	-0.1
Italy	0.0	1.5
United Kingdom	0.0	0.0
Spain	-0.6	0.2
Belgium	0.0	0.0
Denmark	0.0	0.0
Netherlands	0.0	0.0
Sweden	0.0	-0.5
Switzerland	0.0	-0.3

Currency turmoil breeds policy tightening and cuts into confidence in Europe

The recent turmoil in currency markets has largely abated, at least for now. But it has compounded the pressure on the European economies in three key ways.

Overall **monetary** conditions in Europe have firmed slightly as a result of the crisis. Although short-term interest rates have come down in Germany, the United Kingdom, and Switzerland, they have risen more sharply elsewhere. The (GDP-weighted) European short-term rate is up by 18 basis points since the second quarter. Equally, most of the exchange rate adjustments recently have been intra-European, and European currencies have strengthened overall since midyear.

Fiscal announcements since that time have been unambiguously contractionary. To show their commitment to European convergence, or in an effort to restore investor confidence, governments have generally cut back on spending plans, intend to raise taxes, or both. In some cases, these changes would be so extreme as to be doubtfully tenable. Even if some slippage from the revised plans is inevitable in practice, the broad overall thrust of policy is likely to stay contractionary. Moreover, some countries face the risk that less-than-full-blooded adoption of announced plans will bring about the worst outcome: some fiscal contraction, and no offset in the form of lower rates because any fiscal slippage is negatively received in financial markets. The Italian government, in particular, is vulnerable to this dilemma.

Perhaps the most important effect of the recent turmoil will be its damaging effect on business and consumer **confidence**. The extreme moves in some key exchange rates within Europe will inevitably make producers more loath to commit to investment decisions. Similarly, consumers are likely to adopt a "wait-and-see" attitude, even in economies, such as the United Kingdom, where the net impact of recent policy moves has been stimulative.

September's events and reactions dictate recession for Western Europe overall

Compounding preexisting deflationary forces, the policy and confidence reactions to September's events are taking Europe another long step into recession through the first half of 1993.

Since September, the Morgan forecast for **overall European growth** in 1993 has fallen about 1.5 percentage points. The sole exception: an upward revision for the **United Kingdom** after its major monetary easing with sterling out of the ERM.

For the core countries of Europe, growth estimates have come down by about 1 percentage point. For **Germany**, this downward revision connotes an economy in recession through 1993. Indeed, a mild recession may have been in progress through 1992 already. The unemployment rate has risen by a half percentage point, and should rise from its current 6.8% level well above 8% by end-1993.

The neighboring economies – **France, Belgium, Denmark, Switzerland,** and the **Netherlands** – will follow Germany's pattern. For France and Denmark, the potential for weakness is compounded not just by weakness in exports to Germany, but also by the need to keep short-term interest rates higher relative to German rates than earlier seemed likely in an effort to dispel currency concerns.

The **Italian** economy will benefit in its tradable goods sector from a weaker lira. But the economy at large now faces much higher short-term interest rates and an aggressively tighter fiscal policy.

Spain and **Sweden** are the economies where growth projections for next year have been scaled back most dramatically. Their interest rates have climbed sharply at a time when output was already contracting. Belligerent efforts by both their governments to show commitment to strong exchange rates and fiscal tightness raise the potential for further dramatic deteriorations in business conditions in these economies in the months ahead.

Asia/Pacific

Japan. Slower-than-expected output growth through midyear prompts reduced J.P. Morgan real GDP estimates for this year and next. No significant acceleration is envisaged until the second half of 1993.

- Business spending has fallen from the lofty levels of 1990-91, as expected. Less expected – because unemployment remains low and real incomes are rising – consumer spending has stumbled dramatically.
- Consumer goods inventories therefore have ballooned further so far in 1992, rather than falling in line with cutbacks in industrial output. Eventually inventories will fall – but more output weakness than earlier seemed likely will be necessary to complete the inventory cycle.

With growth likely to surprise on the weak side, a bias to easier monetary and fiscal policies remains.

Australia. Currency weakness, related in part to commodity price softness, has sent market interest rates higher at a time when the economy still needs lower rates. Real GDP growth has lost the momentum it displayed earlier in 1992. Instead, it is settling back to around 2.5% – insufficient to cut unemployment against Australia's above-average labor force growth.

Asia/Pacific NICs. The one region of the global economy showing some degree of insulation against current OECD weakness is Southeast Asia. The area is buoyed up by the continued strong growth of intra-Asian trade.

- In China, real GDP soared at a 12-month rate of 11% in the first five months of 1992 and its imports will rise by about 20% for the full year. In sympathy, Hong Kong has rebounded from two years of subpar 3.5% growth, and should attain 6% growth in 1992-93.
- As rapid growth continues, Indonesia's high current account deficit and external debt are a concern, especially if large infrastructure projects with a high import content are revived.

Japan: economic forecast

seasonally adjusted annual rates, percent change quarter over quarter, except as noted

			1992			1993		Q4/Q4 change	
	1992f	1993f	Q2	Q3f	Q4f	Q1f	Q2f	1992f	1993f
Real GDP	1.7	2.1	0.7	0.9	1.3	1.6	2.8	1.6	3.0
% change from year earlier			1.5	1.3	1.6	1.1	1.7		
Private consumption	1.8	1.5	-0.1	0.5	0.5	0.6	2.6	1.1	2.8
% change from year earlier			1.8	1.1	1.1	0.4	1.1		
Business fixed investment	-3.3	-2.1	-9.4	-5.9	-2.0	-2.0	0.4	-4.6	0.1
% change from year earlier			-2.7	-4.9	-4.6	-4.9	-2.4		
Residential investment	-2.6	5.6	10.3	12.6	10.4	4.1	2.0	8.1	2.0
% change from year earlier			-4.9	0.3	8.1	9.3	7.2		
Net exports*	0.8	0.4	0.9	0.7	0.6	0.6	0.2	0.5	0.2
Change from year earlier			0.7	1.0	0.5	0.7	0.5		
Consumer prices (Tokyo)**	2.1	2.2	2.6	2.0	1.7	2.1	2.0	1.7	2.3
Trade balance (sa, customs, $ billion)	108	124	98	119	103	117	131		
Current account (sa, $ billion)	110	124	114	119	105	122	140		

* Percentage-point contributions to real GDP growth. ** Percent change on year earlier.

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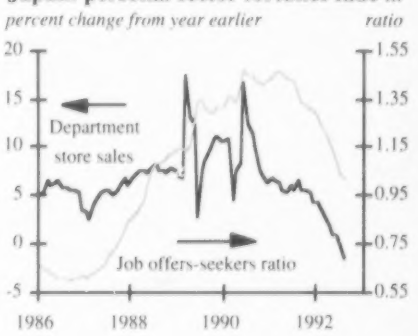
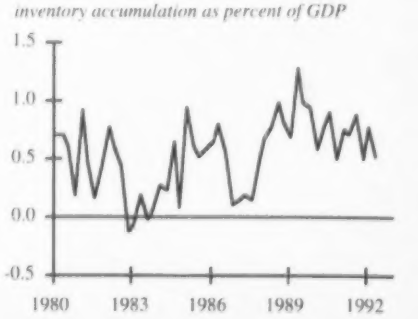


... and inventories build steadily



Main features of Japan's August package

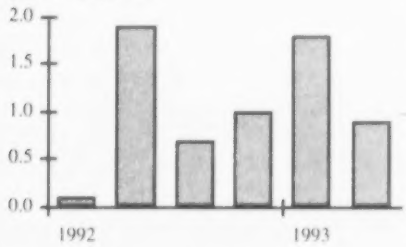
trillions of yen

Additional public works	8.60
General public works	3.40
Restoration, education, research	1.05
Local government public works*	1.80
Public residential construction*	0.80
Land purchases*	1.55
Additional government loans for business investment	2.10
Total of above	10.70
Other measures	
Additional public stock holdings*	1.12
Increased utilities' investment	0.70
Investment tax cut	0.30

*All or partly FILP-financed.

Public works contribution to Japan's real GDP growth

quarter-to-quarter contribution, saar, percentage points



Japan: Tax cuts – likely to be unveiled soon – will add to fiscal stimulus

Recent Japanese domestic demand has been much weaker than expected. In August, the authorities responded by announcing massive stimulus through public lending and public works spending. The package, as announced, totaled a huge ¥10.7 trillion ($88 billion), or 2.3% of GDP. Its near-term effect on demand, however, will be nowhere near as sizable. Tax cuts, of at least ¥1 trillion and probably to be unveiled toward the end of 1992, now loom as the next step to bolster economic growth.

More than half the August package, and its main support for the economy, comes as increases in the "Fiscal Investment and Loan Program." Through it, the authorities will channel postal savings funds into a wide range of investment spending: direct infrastructure investment, as well as loans to promote private sector residential and business investment. Because FILP disbursements to private uses will occur only in support of private sector investment demand, their stimulative powers for the economy are questionable. Still, they will add about one percentage point to real GDP growth in the first half of 1993 – and thus account for virtually all the growth expected.

The second feature of the August package seeks to support the financial markets (especially the stock market). It is to provide a public fund to buy stocks and postpone some privatizations, but its economic benefits may not be substantial.

The continued sluggishness of private final demand – especially consumer demand – and the resultant continuing rise in inventories suggest that pressures are likely to build for further policy stimulus. Yet monetary easing could reverse the yen's recent appreciation and aggravate concern (certainly abroad) over Japan's rising trade surplus. Japan's partners eye the (general government) budget surplus in Japan as offering obvious room for further fiscal stimulus. To please both domestic and international interests, the Japanese authorities will likely oblige anew on the fiscal front.

Australia's consumers not optimistic ...

index, consumer confidence

... but CPI expectations stay subdued

expected CPI inflation, percent

Australia: Consumer hesitancy holds back economic recovery

In the first half of 1992, Australia's real GDP resumed growth at a respectable 3% (saar). Buoyed by domestic demand, growth was expected to accelerate in the second half and into 1993. Recent readings, however, have been disappointing. As in so many other economies, Australia's growth has stalled.

One factor promoting overall growth confidence earlier in the year, despite the over-leveraged condition of the business sector, was the strength of consumer sector indicators. Retail trade turnover soared in the early months of 1992, spurred by a brief dose of stimulus provided in February's "One Nation" fiscal statement. Confidence revived to the 80-120 range that is the norm for business cycle upturns. In addition to the stimulative stance of both monetary and fiscal policies, optimism on the consumption outlook owed much to the belief that the balance sheet difficulties that had restrained consumption in many other English-speaking economies were less severe in Australia. One sign of these lesser constraints was the sharp rise in housing finance approvals. Whereas, for example, 1992 U.K. building society net lending is 40% below its 1989-90 peak, Australia's loan approvals have risen back toward their 1988 peak, or almost double their early-1990 trough.

In fact, consumer spending and confidence have leveled off significantly since the spring. Consumers are fundamentally pessimistic about their jobs and incomes prospects. Record high unemployment is undermining perceived job security: Unemployment is unlikely to drop below 10% (currently 10.8%) before end-1993. Moreover, consumers' inflation expectations have dropped to their lowest since surveys began in the mid 1960s. Since such price expectations form the basis of wage expectations, consumers' perceived income growth has dipped to a rate warranting caution.

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Effective exchange rates

*index numbers, 1980-82 average = 100**

	1989	1990	1991	1991 Q3	1991 Q4	1992 Q1	1992 Q2	1992 Q3	1991 Sep	1992 May	1992 Jun	1992 Jul	1992 Aug	1992 Sep
Nominal against 15 industrial-country currencies														
United States	91.3	86.5	85.5	87.6	84.0	84.8	85.2	81.5	86.1	85.5	83.7	81.7	80.9	81.7
Japan	172.8	156.8	170.0	170.4	175.3	176.9	174.3	176.6	171.2	173.9	177.4	175.7	173.8	180.3
Canada	100.5	100.7	102.5	103.3	103.2	99.5	97.9	96.3	103.5	97.6	97.4	97.2	97.0	94.7
Australia	65.6	62.4	61.5	63.2	61.0	58.5	59.0	54.6	63.2	58.9	57.7	55.8	53.9	54.0
Germany	121.0	124.9	124.2	123.4	125.0	125.2	125.1	127.8	124.0	124.8	125.4	126.6	127.6	129.2
France	84.9	88.2	86.8	86.2	86.9	87.3	88.2	89.6	86.4	88.2	88.5	89.2	89.3	90.4
Italy	80.6	81.3	80.3	79.9	80.2	80.3	79.9	79.1	80.1	79.9	79.8	80.4	80.8	76.1
United Kingdom	81.3	79.3	80.0	79.3	79.3	79.0	80.5	78.9	79.5	80.9	81.0	80.4	79.9	76.5
Belgium	94.2	97.7	97.8	97.2	98.2	98.3	98.1	99.5	97.5	97.9	98.2	98.9	99.4	100.3
Denmark	99.0	104.7	103.3	102.4	103.2	103.2	103.4	105.5	103.0	103.2	103.9	104.9	105.4	106.2
Netherlands	113.6	116.4	115.7	115.2	116.3	116.5	116.2	118.1	115.5	116.1	116.4	117.2	117.9	119.1
Spain	78.9	81.8	81.8	81.0	81.3	81.7	81.9	81.1	81.3	82.2	82.1	82.2	82.1	79.0
Sweden	81.2	79.0	78.9	78.5	79.1	79.7	80.0	80.9	78.6	80.0	80.2	80.8	81.1	80.7
Switzerland	115.8	121.3	119.7	117.9	117.7	115.7	113.3	119.2	117.9	112.7	114.8	117.4	118.3	121.9
Real (relative wholesale-price adjusted) against 18 other industrial-country currencies and 22 emerging-market currencies														
United States	96.9	92.7	92.3	93.8	91.1	91.5	91.6	88.1	92.3	91.7	90.2	88.4	87.6	88.4
Japan	121.8	107.8	114.9	115.4	117.3	117.3	115.0	115.0	115.4	114.8	116.3	114.7	113.0	117.3
Canada	107.9	103.5	102.4	103.3	102.0	99.4	97.8	95.6	102.9	97.7	96.9	96.4	96.4	94.1
Australia	98.6	94.8	93.6	95.6	92.3	87.9	87.7	81.1	95.7	87.6	85.8	83.0	80.1	80.1
Germany	105.4	108.7	106.8	105.4	107.0	107.3	107.4	110.9	106.1	107.2	107.8	109.6	110.8	112.4
France	100.7	104.7	103.1	102.2	103.8	104.4	105.5	108.0	102.6	105.6	106.1	107.3	107.7	109.1
Italy	108.1	110.5	107.9	106.8	107.4	106.9	105.9	105.3	107.1	105.8	105.9	106.9	107.5	101.3
United Kingdom	94.6	96.6	100.1	98.9	99.4	99.6	101.6	100.3	99.3	102.0	102.3	102.0	101.5	97.5
Belgium	80.5	85.0	85.6	85.0	86.8	87.5	86.1	87.9	85.5	85.8	86.8	87.1	87.7	88.9
Denmark	106.6	112.1	109.1	107.4	109.7	108.3	109.0	110.5	109.0	109.3	109.1	108.8	110.3	112.5
Netherlands	97.3	99.9	98.8	98.0	100.3	99.4	100.9	103.7	99.3	101.0	100.8	102.6	103.7	104.8
Spain	110.0	116.8	117.9	116.4	117.7	118.6	118.4	118.1	117.1	118.6	118.7	119.3	119.8	115.3
Sweden	105.5	104.0	102.6	101.9	102.7	103.7	103.3	104.9	102.2	103.2	103.6	104.4	105.3	105.1
Switzerland	106.6	115.1	116.4	114.5	115.6	114.4	112.2	118.7	115.0	111.2	113.8	116.3	117.8	122.1
Argentina	50.1	58.9	69.3	69.2	67.6	67.0	68.1	66.8	68.3	68.0	67.7	66.5	66.3	67.4
Brazil	98.5	118.0	89.5	95.0	85.4	83.1	82.1	79.2	94.4	83.1	81.9	80.4	79.1	78.0
Chile	62.4	60.0	65.4	66.7	65.8	69.8	72.4	68.1	66.0	72.8	71.3	68.8	67.6	68.0
Mexico	74.0	69.2	74.7	76.1	74.2	74.5	75.5	74.6	75.8	75.6	75.1	74.5	74.4	74.9
Venezuela	62.1	52.4	51.8	52.0	52.5	51.3	52.8	52.6	52.0	52.6	53.0	52.6	52.5	52.7
Hong Kong	98.8	99.1	105.6	107.7	108.8	108.5	112.1	106.8	107.3	112.6	112.3	106.7	105.5	108.1
Indonesia	55.7	54.8	54.8	56.4	54.5	54.7	54.4	52.2	55.6	54.4	53.4	52.3	52.1	52.2
Korea	92.3	85.1	83.5	85.1	80.3	78.7	77.1	74.4	83.4	77.4	75.5	74.9	74.0	74.2
Malaysia	80.0	76.3	76.1	77.1	75.9	80.4	83.1	80.8	76.4	83.4	82.1	81.2	80.5	80.6
Philippines	95.7	88.8	87.3	90.6	91.7	94.3	93.7	98.2	91.5	93.0	93.2	95.6	98.8	100.2
Singapore	78.2	80.7	83.2	84.4	84.7	86.4	86.2	84.1	84.1	86.3	85.5	84.3	83.9	84.0
Taiwan	100.9	94.1	92.9	94.1	92.6	93.5	94.1	90.6	93.5	94.3	93.9	92.3	90.1	89.4
Thailand	77.7	75.1	78.4	79.7	76.7	76.4	75.8	73.0	78.5	75.7	75.3	73.4	72.7	73.1

*A currency's nominal effective exchange rate is an index of its trade-weighted average value against the currencies of the country's principal trade partners. The real effective exchange rate, which adjusts the nominal index for relative price changes, gauges the effect on the international price competitiveness of the country's manufactures due to currency changes and differential inflation. The relative price changes are based on indices most closely measuring the prices of domestically produced finished manufactured goods, excluding food and energy at the first stage of manufacturing. The weights for the currency indices are derived from 1980 bilateral trade patterns of the corresponding countries.

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Bond Index Group
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J.P. Morgan Government Bond Index: total return performance

percent change, end of period from like preceding period

				1991				1992					
	1989	1990	1991	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul	Aug	Sep
In local currency terms													
United States	14.0	8.6	14.8	1.9	1.4	5.5	5.3	-1.6	4.0	4.9	2.4	1.0	1.5
Japan	-1.5	0.8	13.8	2.1	0.5	6.1	4.4	1.8	1.9	4.7	2.4	1.0	1.3
Canada	12.8	7.4	21.0	5.9	0.3	7.3	6.2	-1.4	6.1	2.8	4.6	0.9	-2.7
Australia	13.7	18.8	26.3	5.3	3.7	6.5	8.6	-1.1	7.9	0.9	3.6	-3.6	1.1
Germany	1.0	1.1	11.9	4.1	1.9	2.3	3.1	2.4	1.6	4.4	0.2	1.2	2.9
France	4.1	7.3	15.9	6.4	2.1	3.4	3.2	1.3	1.9	2.4	-1.2	0.7	3.0
Italy	12.0	14.6	17.2	4.9	3.9	4.0	3.4	3.1	0.7	-0.5	-2.6	1.7	0.5
United Kingdom	8.0	9.5	16.8	6.7	0.8	7.2	1.3	1.5	6.3	2.9	-0.3	-1.0	4.2
Belgium	2.0	8.8	13.3	4.9	2.1	2.9	2.7	2.2	2.3	3.3	0.0	0.5	2.8
Denmark	5.0	10.2	16.1	6.2	2.7	2.9	3.5	1.2	1.4	-0.3	-1.4	0.1	1.0
Netherlands	-0.2	3.3	11.4	3.9	2.1	1.9	3.1	2.9	2.5	4.9	0.0	1.0	3.9
Spain	9.2	14.8	17.5	6.5	4.3	3.8	1.9	3.3	0.6	-3.9	-2.1	-1.1	-0.8
Sweden	2.2	14.8	20.2	6.1	5.5	5.4	2.0	3.8	1.3	-2.3	-0.6	-2.7	1.0
ECU	..	7.4	16.2	5.9	2.5	3.8	3.2	1.3	1.0	-0.4	-2.6	-0.3	2.6
In dollars													
United States	14.0	8.6	14.8	1.9	1.4	5.5	5.3	-1.6	4.0	4.9	2.4	1.0	1.5
Japan	-14.5	7.2	23.4	-1.7	2.7	9.9	11.2	-4.4	7.6	9.7	1.2	4.4	3.8
Canada	16.1	7.2	21.5	6.0	1.8	8.2	4.0	-4.2	5.4	-1.3	5.9	-0.1	-6.8
Australia	5.1	16.2	24.3	5.6	2.6	11.0	3.3	0.2	4.7	-3.7	3.1	-7.4	0.8
Germany	5.6	14.8	9.8	-8.7	-4.2	11.2	13.0	-5.6	9.6	12.3	3.3	6.8	1.7
France	8.9	22.4	13.4	-6.1	-4.2	11.8	12.7	-5.9	10.8	9.5	1.5	5.2	2.5
Italy	15.5	28.8	15.1	-6.2	-2.4	12.4	11.9	-4.4	8.3	-8.0	0.4	6.2	-13.8
United Kingdom	-3.7	31.3	12.8	-3.6	-6.4	15.7	8.1	-5.7	16.4	-3.9	0.8	2.5	-7.0
Belgium	6.7	25.2	12.0	-7.3	-4.0	11.8	12.5	-5.5	10.3	11.0	3.1	5.9	1.7
Denmark	9.1	25.6	13.5	-6.4	-3.5	11.9	12.4	-6.3	10.5	6.8	1.3	5.2	0.2
Netherlands	4.5	17.2	9.5	-8.7	-4.1	10.8	12.9	-5.1	10.5	12.9	3.1	6.7	2.6
Spain	13.1	31.1	16.6	-3.4	-2.7	11.6	11.2	-3.9	8.6	-7.0	0.1	2.4	-9.3
Sweden	0.7	26.4	22.2	-3.0	-0.4	13.3	11.6	-3.7	9.8	1.3	2.0	2.0	-2.7
ECU	..	24.3	12.9	-6.6	-4.0	12.3	12.1	-6.0	9.4	2.4	-0.1	4.3	-1.7
Global	6.8	11.8	15.5	-0.8	-0.1	8.0	7.8	-3.1	6.5	4.8	2.2	2.7	-0.1
Global excluding United States	-2.4	15.6	16.0	-4.3	-2.0	11.4	10.9	-4.9	9.5	4.7	2.0	4.5	-1.7

J.P. Morgan Government Bond Index: 10-year constant-maturity yields

*percent per annum, semiannual basis**

				1991				1992					
	1989	1990	1991	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul	Aug	Sep
United States	7.91	8.06	6.69	8.03	8.23	7.45	6.69	7.52	7.13	6.35	6.69	6.66	6.35
Japan	5.59	6.65	5.57	6.58	6.78	6.07	5.57	5.54	5.51	4.90	5.24	5.07	4.90
Canada	9.56	10.28	8.25	9.52	10.06	9.09	8.25	8.76	8.18	8.34	7.41	7.59	8.34
Australia	12.93	12.05	9.39	11.38	11.16	10.32	9.39	9.85	8.88	8.95	8.29	8.97	8.95
Germany	7.26	8.99	8.05	8.51	8.49	8.38	8.05	8.02	8.01	7.50	8.16	7.89	7.50
France	9.37	9.97	8.57	9.10	9.16	8.87	8.57	8.67	8.80	8.71	9.22	9.17	8.71
Italy	14.08	14.54	12.88	13.68	13.32	12.90	12.88	12.76	13.19	14.15	14.11	13.95	14.15
United Kingdom	10.20	10.96	9.75	10.12	10.49	9.58	9.75	9.87	9.16	8.97	9.33	9.65	8.97
Belgium	9.42	9.97	8.88	9.36	9.35	9.10	8.88	8.87	8.87	8.64	9.05	9.10	8.64
Denmark	10.25	10.49	8.73	9.38	9.28	9.06	8.73	8.90	8.96	9.52	9.51	9.64	9.52
Netherlands	7.84	9.15	8.56	8.73	8.75	8.77	8.56	8.37	8.31	7.80	8.43	8.32	7.80
Spain	14.12	14.60	11.27	12.52	11.94	11.30	11.27	10.91	11.51	13.51	12.30	12.93	13.51
Sweden	12.75	12.08	9.90	11.49	10.70	9.96	9.90	9.48	9.59	10.82	10.02	10.84	10.82

*For each of the J.P. Morgan Government Bond Index countries, the data are calculated as the semiannual yield of the single most liquid bond component within four months of the stated maturity.

New York
October 23, 1992

Morgan Guaranty Trust Company
Economic Research
Saurin Shah (1) 212-648-6520

World Financial Markets
September/October 1992

Global economic outlook in summary

percent change from previous year, except as noted; group averages and totals are for countries listed

					Consumer prices			Current account					
	Nominal GDP/GNP	Real GDP/GNP			Dec-Dec			$ billions			% of GDP/GNP		
	$ billions, 1991	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993
Industrial countries	16579	0.8	1.3	1.1	3.7	2.9	2.8	-19	-42	-21	-0.1	-0.3	-0.2
United States	5678	-1.2	1.7	1.7	2.9	2.8	2.0	-3.7	-56.2	-68.6	-0.1	-1.0	-1.1
Japan	3225	4.4	1.7	2.1	3.2	1.5	2.2	72.6	109.8	124.4	2.3	3.1	3.4
Canada	593	-1.5	1.1	2.3	4.1	1.8	2.3	-25.5	-23.6	-19.5	-4.3	-4.1	-3.5
Australia	301	-2.0	2.0	2.5	1.5	0.5	2.3	-10.4	-9.3	-9.5	-3.4	-3.1	-3.1
Western Europe	6782	1.0	0.8	-0.1	4.6	3.8	3.7	-52.3	-62.8	-47.6	-0.8	-0.9	-0.8
Germany	1573	3.6	1.0	-0.8	4.2	3.7	3.4	-19.8	-26.0	-15.7	-1.3	-1.5	-0.9
France	1190	1.3	1.8	0.0	3.1	2.6	2.5	-5.9	-1.3	-1.5	-0.5	-0.1	-0.1
Italy	1151	1.4	1.1	-0.5	6.0	5.1	6.9	-21.1	-23.9	-22.3	-1.8	-2.0	-2.2
United Kingdom	1041	-2.4	-0.9	0.9	4.5	3.7	3.0	-11.2	-21.2	-23.1	-1.1	-2.0	-2.4
Belgium	198	1.6	1.3	0.3	2.8	3.2	2.8	4.6	5.2	5.4	2.3	2.4	2.4
Denmark	129	1.0	1.0	0.0	2.3	2.5	2.6	2.2	2.7	2.6	1.7	1.9	1.9
Finland	135	-6.1	-1.9	1.1	3.9	3.0	2.6	-5.8	-4.5	-1.6	-4.3	-3.5	-1.5
Netherlands	277	2.1	1.5	0.6	4.9	3.5	2.8	9.4	13.0	14.0	3.4	4.2	4.5
Norway	107	1.5	1.4	1.5	2.9	3.0	3.0	5.1	5.3	4.5	4.8	4.6	4.6
Spain	515	2.4	1.5	-1.1	5.6	6.4	5.0	-15.4	-21.8	-21.0	-3.0	-3.9	-4.1
Sweden	238	-1.4	-2.0	-3.1	7.9	2.1	1.9	-3.3	-0.3	1.1	-1.4	-0.1	0.5
Switzerland	229	-0.4	-0.5	0.0	5.2	3.0	2.5	8.9	10.1	10.1	3.9	4.1	4.2
Emerging markets	3594	1.5	1.0	1.1	...	...	...	-4.6	-30.0	-41.3	-0.1	-1.0	-1.1
Europe	1073	-6.8	-8.8	-8.6	...	...	...	3.7	1.5	-5.1	0.3	-0.7	-0.5
Greece	69	1.5	1.5	1.5	18.0	15.0	13.0	-1.5	-1.3	-1.8	-2.2	-1.7	-2.2
Portugal	67	2.2	2.3	2.1	9.6	7.9	6.5	-0.7	0.3	1.7	-1.1	0.4	2.0
Turkey	109	0.3	5.0	5.5	71	60	50	0.3	1.0	0.6	0.2	0.9	0.6
Czechoslovakia	35	-12.5	-5.0	2.0	54	12.5	9.5	0.4	1.4	1.8	1.0	3.9	4.8
Hungary	33	-8.5	-3.5	1.3	34	22	18.7	0.3	1.1	1.7	1.0	3.2	4.5
Poland	80	-10.0	-1.8	0.0	60	60	45	-1.4	0.1	0.6	-1.7	0.6	1.2
Russia	680	-8.9	-14.4	-15.0	169	2140	500	6.3	-2.0	-9.7	0.9	-1.6	-1.4
Latin America	1007	3.3	3.1	3.0	...	...	...	-16.2	-29.6	-32.7	-1.6	-2.8	-3.1
Argentina	132	6.0	6.5	4.5	84	20	12	-2.5	-5.6	-8.1	-1.9	-3.3	-3.8
Brazil	403	1.2	2.5	3.0	475	950	350	-2.4	1.5	-1.1	-0.6	0.4	-0.4
Chile	31	6.0	7.5	6.0	18.7	13.0	10.0	0.1	-0.9	-0.7	0.3	-2.4	-1.5
Colombia	42	2.3	2.0	3.3	26.8	26.0	20.0	2.5	1.0	0.4	5.9	2.2	0.9
Ecuador	12	4.4	2.0	3.3	49	55	34	-0.5	-0.4	-0.4	-3.9	-3.3	-2.8
Mexico	282	3.6	2.6	2.3	18.8	11.5	8.8	-13.3	-21.3	-18.6	-4.7	-6.6	-5.3
Peru	52	2.9	1.0	2.5	139	50	40	-1.8	-2.6	-2.9	-3.4	-5.2	-4.7
Venezuela	53	10.4	3.4	2.0	31	36	32	1.7	-1.3	-1.3	3.1	-2.2	-2.1
Asia/Pacific	1514	6.2	6.5	6.7	8.2	7.7	7.7	8.0	-2.0	-3.6	0.5	-0.1	-0.2
China	362	7.3	8.0	8.0	6.0	7.5	9.5	13.8	8.0	3.6	3.8	2.0	0.8
India	267	2.0	3.5	4.5	13.1	12.5	9.5	-5.5	-5.8	-5.0	-2.1	-2.2	-1.8
Hong Kong	81	3.9	6.0	6.0	10.0	10.0	12.0	9.3	5.0	3.3	11.4	5.3	2.9
Indonesia	119	6.6	5.5	5.5	9.9	7.0	6.5	-4.1	-4.8	-4.1	-3.4	-3.7	-2.9
Korea	281	8.4	7.0	7.0	9.2	7.0	7.0	-8.7	-7.0	-6.0	-3.1	-2.3	-1.9
Malaysia	47	8.8	9.5	8.9	4.2	5.1	5.3	-4.4	-3.5	-1.5	-9.3	-6.0	-2.2
Philippines	46	-0.1	3.5	4.5	13.1	9.5	8.5	-1.0	-2.0	-2.0	-2.3	-3.5	-3.3
Singapore	39	6.7	5.3	6.0	2.9	2.4	2.7	4.2	4.5	4.4	10.7	9.4	8.8
Taiwan	180	7.3	8.0	7.5	4.4	4.0	4.5	12.0	10.0	8.0	6.7	4.6	3.2
Thailand	92	8.2	7.5	7.5	4.7	4.4	4.6	-7.6	-6.4	-4.2	-8.3	-6.2	-3.8

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